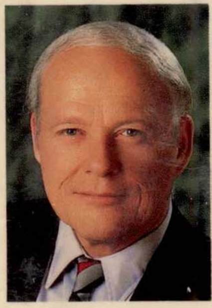

How to Make Money in Stocks

A Winning System in Good Times or Bad

William J. O'Neil
Founder of INVESTOR'S DAILY

How to Make Money in Stocks

A Winning System in Good Times or Bad

William J. O'Neil

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How to make money in stocks: a winning system in good times or bad

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1. Investments. 2. Stocks. I. Title.
HG4521.0515 1988
332.63'22--dc19 87-32486
ISBN 0-07-047760-4

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34567890 DOCDOC 8921098

ISBN 0-07-047760-4

The editors for this book were William A. Sabin and Caroline Levine. The designer was Naomi Auerbach and the production supervisor was Richard Ausburn. It was set in Baskerville by the McGraw-Hill Book Company Professional and Reference Book composition unit.

Printed and bound by R. R. Donnelley & Sons.

Preface

From August 1982 to August 1987, the stock market staged a phenomenal 250% increase. Employees' pension funds made a fortune. Then in one day in October 1987, the market dropped a record 24%. Sanity and reality returned. That's the stock market.

During the last 50 years, we have had twelve bull (up) markets and eleven bear (down) markets. But guess what? The bull markets averaged going up about 100% and the bear markets, on an average, declined 25% to 30%. Not only that, the typical bull market lasted 3 3/4 years and the classic bear market lingered only nine months. Viewed with perspective . . . that's a terrific deal.

But I will go you one better. Did you know that in the last 100 years we have had more than 25 bear market slumps (natural, normal corrections of the previous bull market advance), and EVERY SINGLE TIME THE MARKET RECOVERED AND ULTIMATELY SOARED INTO NEW HIGH GROUND? That's fantastic.

What causes this continued long-term growth and upward progress? It's one of the greatest success stories in the world—free people, in a free country, with strong desires and the incentives to unceasingly improve their circumstances.

The stock market does not go up due to greed, it goes up because of new products, new services, and new inventions . . . and there are hundreds of them every year. The innovative entrepreneurial companies with the best quality new products that serve people's needs are always the top stock market winners.

So, why haven't more people taken advantage of these tremendous investment opportunities? Answer: they don't understand the market, and when you don't understand something you are unsure, maybe even afraid.

I am going to solve that problem for you. This book will explain the market to you in simple terms everyone can understand. It will show you how to select which stocks to buy and exactly when you should buy and when you should sell. There are two entire chapters on when to sell and nail down your profits or cut short potential mistakes. You can learn how to protect yourself against the big risks in good times or bad.

There are three things I feel absolutely certain about concerning the next twenty-five years. The government will continue to tax you as much as they possibly can for as long as you live, your cost of living will go up substantially, and the stock market and economy will be much higher. You can't do a lot about the first two items, but you can benefit materially from the last one if you learn how to save and invest properly.

Don't be thrown off by the swarm of gloom and doomers. In the long run, they have seldom made anyone any money or provided any real happiness. I have also never met a successful pessimist.

There is one overpowering, overriding reason why there should be other bull markets ahead—the enormous number of baby boomers in the 30- and 40-year-old age brackets. Marriages will be up and couples will need housing, furniture, medical care, clothing, and education for all the new children. This giant bulge in future demand will not go away.

Everyone should own common stock! It's a great way to get an extra income, financial independence, and security. It's a way you can "be in business for yourself," and it can be safe and sound over the long term . . . if you learn to correctly apply all the basic rules for making and protecting your gains and minimizing losses. It could put your kids through school, dramatically increase your standard of living, and give you freedom and safety in your old age.

I have spent 30 years analyzing how the U.S. economy works. William O'Neil & Co., Inc., also built the first daily computer data base on the stock market in this country and used it to construct models of "what the most successful companies looked like just before they became big successes."

In 1970, we moved into the institutional stock research business. We called our first service *Datagraphs*. Today we are regarded by some institutional investors as the leader in automation in the securities analysis and management field. A daily chart service was also developed called *Daily Graphs* to which thousands of individual investors subscribe.

Later in 1983, I designed and created the basic format for *Investor's Daily*, a national business newspaper. It was the first paper to make significant improvements in news available to public investors via daily stock price tables. A completely separate organization was then set up to directly challenge the sacred 100-year-old east coast-based industry giant, *The Wall Street Journal.*

My prime objective in writing this book is to help *everyone* discover how to get ahead by saving and investing.

I'm talking about ordinary people who have never owned stocks; those deeply concerned about inflation and their dwindling dollar; everyday individuals investing in a local savings account, a money market fund, or a mortgage; people who may have bought a little art, gold, or silver.

This book will also help renters who dream of one day buying a home or income property, and those investors who already enjoy home ownership. It is for amateur investors in the stock market, people considering an IRA (Individual Retirement Account) or a mutual fund, retired persons, teachers of investment courses, and students attempting to learn about investments.

Lastly, this book is for sophisticated professionals managing pension and mutual funds, whose difficult job it is to produce investment results and stay ahead in a very complex and confusing game.

It is also for those who seek professional advice in the supervision of state and public employee funds and educational and charitable investment portfolios, and for foreign investors who want to invest money in the U.S.A., the land of unmatched personal freedom and opportunity.

My deep appreciation and heartfelt thanks go out to those loyal hardworking souls who read, edited, worked on the graphics, criticized, typed, and retyped the endless changes made to this work. Some of those dedicated individuals are Anne Gerhard, Carolyn Hoffman, Jim Lan, Stanley Liu, Diane Marin, Milton Perrin, Kathy Russell, Lindee Shadrake, Kathy Sherman, Frank Spillers, and Susan Warfel. And, of course, a great amount of valuable assistance and numerous suggestions were provided by my wife Fay and Bill Sabin and his excellent McGraw-Hill staff.

William J. O'Neil

Contents

Preface V

Part 1 A Winning System: C-A-N S-L-I-M

Introduction: Learning from the Greatest Winners 2

1. C = Current Quarterly Earnings Per Share: How Much Is Enough? 5
2. A = Annual Earnings Increases: Look for Meaningful Growth 14
3. N = New Products, New Management, New Highs: Buying at the Right Time 22
4. S = Shares of Common Stock Outstanding: Keep It Small 28
5. L = Leader or Laggard: Which Is Your Stock? 33
6. I = Institutional Sponsorship: A Little Goes a Long Way 38
7. M = Market Direction: How to Determine It 42

Part 2 Be Smart from the Start

8. Finding a Broker, Opening an Account, and What It Costs to Buy Stocks 76
9. When to Sell if Your Selection or Timing Might Be Wrong 81

10. When to Sell and Take Your Profit 93

11. Should You Diversify, Invest for the Long Pull, Buy on Margin, Sell Short? 105

12. Should You Buy Options, OTC Stocks, Mutual Funds, New Issues . . . ? 111

Part 3 Investing like a Professional

13. Models of the Greatest Stock Market Winners: 1953–1985 132

14. How to Read Charts like an Expert and Improve Your Stock Selection and Timing 150

15. How to Make Money Reading the Daily Financial News Pages 169

16. The Art of Tape Reading: Analyzing and Reacting to News 194

17. How to Pick the Best Industry Groups, Subgroups, and Market Sectors 205

18. Improving Management of Pension and Institutional Portfolios 216

19. 18 Common Mistakes Most Investors Make 238

Appendix: +135,000% . . . A Great Continuing Growth Story 242

Index 243

PART 1

A Winning System: C-A-N S-L-I-M

Introduction: Learning from the Greatest Winners

In the following chapters, I will show you how to pick more big winners in the stock market and how to substantially reduce your losses and mistakes. I will examine and discuss other investments, as well.

In the past, most people who bought and sold stocks either had mediocre results or lost money because of their clear lack of knowledge. But no one has to lose money.

This book should provide you with most of the investment understanding, skills, and methods you need to become a more successful investor.

I believe that most people in this country and many others throughout the free world, young and old, regardless of profession, education, background, or economic position, can and definitely should own common stock. This book isn't written for an elite but for the millions of little guys everywhere who want a chance to be better off.

YOU CAN START SMALL

If you are a typical working man or woman or a beginning investor, it doesn't take a lot of money to start. You can begin with as little as $500 to $1000 and add to it as you earn and save more money. I began with the purchase of just five shares of Procter & Gamble when I was only 21 and fresh out of school.

You live in a fantastic time of unlimited opportunity, an era of outstanding new ideas, emerging industries, and new frontiers, but you have to read to learn how to recognize and take advantage of these extraordinary situations.

The opportunities are out there for everyone. One remarkable new break for many Americans is the widely advertised IRA plan. You may be able to invest and earn tax-free until age 70 if the company you work for does not have a pension fund program. Another benefit is the new, lower tax rates on ordinary gains. These are tremendous advantages every individual should know about and act upon.

It is not enough today to just work and earn a salary. To do the things you want to do, to go the places you want to go, to have the things you want to have in your life, **you absolutely must save and invest intelligently**. The second income from your investments and the net profits you can make will help you reach your goals and provide real security.

SECRET TIP #1 The first step in learning to pick stock market winners is for you to examine leading winners of the past to learn all the characteristics of the most successful stocks. You will learn from this observation what type of price patterns these stocks developed just before their spectacular price advances.

Other key factors you will uncover include what kind of company quarterly-earnings reports were publicly known at the time, what the annual earnings histories of these organizations had been in the prior five years, what amount of stock trading volume was present, what degree of relative price strength occurred in the price of the stocks before their enormous success, how many shares of common stock were outstanding in the capitalization of each company, how many of the greatest winners had significant new products or new management, and how many were tied to strong industry group moves caused by important changes occurring in an entire industry.

It is easy to conduct this type of practical, commonsense analysis of past successful leaders. I have already completed such a comprehensive study. In our historical analysis, we selected the greatest winning stocks in the stock market each year (in terms of percentage increase for the year), spanning more than 30 years.

We call the study *The Record Book of Greatest Stock Market Winners.* It covers the period from 1953 through 1985 and analyzes in detail over 500 of the biggest winning companies in recent stock market history: super stocks such as Texas Instruments, whose price soared from $25 to $250 from January 1958 through May 1960; Xerox, which escalated from $160 to the equivalent of $1340 from March 1963 to June 1966;

Syntex, which leaped from $100 to $570 in only six months during the last half of 1963; Dome Petroleum and Prime Computer, which respectively advanced 1000% and 1595% in the 1978–1980 stock market; and Limited Stores, which wildly excited lucky shareowners with a 3500% increase between 1982 and 1987.

Would you like to know the common characteristics and secret rules of success we discovered from this intensive study of all past glamorous stock market leaders?

It's all in the next few chapters and in a simple easy-to-remember formula we have named *C-A-N S-L-I-M.* Write the formula down, and repeat it several times so you won't forget it.

Each letter in the words *C-A-N S-L-I-M* stands for one of the seven chief characteristics of these great winning stocks at their early developing stages, just before they made huge profits for their shareholders.

You can learn how to pick winners in the stock market, and you can become part owner in the best companies in the world. So, let's get started right now. Here's a sneak preview of *C-A-N S-L-I-M*.

C = Current Quarterly Earnings Per Share: How Much Is Enough?

A = Annual Earnings Increases: Look for Meaningful Growth.

N = New Products, New Management, New Highs: Buying at the Right Time.

S = Shares of Common Stock Outstanding: Keep It Small.

L = Leader or Laggard: Which Is Your Stock?

I = Institutional Sponsorship: A Little Goes a Long Way.

M = Market Direction: How to Determine It?

Please begin immediately with Chapter 1.

1

C = Current Quarterly Earnings Per Share: How Much Is Enough?

M/A-Com Inc.
Humana Inc.
Kirby Exploration Co.

What did shares of the above-mentioned microwave component manufacturer, hospital operator, and oil service company have in common? From 1977 to 1981, they all posted price run-ups surpassing 900%.

In scrutinizing these and other past stock market superstars, I've found a number of other similarities as well.

For example, trading volume in these sensational winners swelled substantially before their giant price moves began. The winning stocks also tended to shuffle around in price consolidation periods for a few months before they broke out and soared. But one key variable stood out from all the rest in importance: the profits of nearly every outstanding stock were booming.

The common stocks you select for purchase should show a major percentage increase in the current quarterly earnings per share (the most recently reported quarter) when compared to the prior year's same quarter.

Earnings per share are calculated by dividing a company's total after-tax profits by the company's number of common shares outstanding. The percentage increase in earnings per share is the single most important element in stock selection today.

The greater the percentage of increase, the better, as long as you aren't misled by comparing current earnings to nearly nonexistent earnings for the year earlier quarter, like 1 or 2 cents a share.

Ten cents per share versus one cent may be a 900% increase, but it is definitely distorted and not as meaningful as $1 versus $.50. The 100% increase of $1 versus $.50 is not overstated by comparison to an unusually low number in the year ago quarter.

I am continually amazed at how many professional pension fund managers, as well as individual investors, buy common stocks with the current reported quarter's earnings flat (no change), or even worse, down. There is absolutely no reason for a stock to go anywhere if the current earnings are poor.

Even if the present quarter's earnings are up 5 to 10%, that is simply not enough of an improvement to fuel any significant upward price movement in a stock. It is also easier for a corporation currently showing a mere increase of 7 or 8% to suddenly report lower earnings the next quarter.

Seek Stocks Showing Big Current Earnings Increases

In our models of the 500 best performing stocks in the 33 years from 1953 through 1985, three out of four of these securities showed earnings increases averaging more than 70% in the latest publicly reported quarter *before* the stocks began their major price advance. The one out of four that didn't show solid current quarter increases did so in the very next quarter, and those increases averaged 90%!

If the *best* stocks had profit increases of this magnitude *before* they advanced rapidly in price, why should you settle for mediocre or down earnings?

Our study showed that among all big gainers between 1970 and 1982, 86% reported higher earnings in their most recently published quarter, and 76% were up over 10%. The median (most common) earnings increase was 34% and the mean (average) was up 90%.

You may find that only about 2% of all stocks listed for trading on the New York or American stock exchanges will, at any one time, show increases of this proportion in current quarterly net income.

But, remember you want to find the exceptional stocks rather than the lackluster ones, so set your sights high and start looking for the superior stocks, the small number of real leaders. They are there.

Success is built on dreams and ideas; however, it helps to know exactly what you're looking for. Before you start your search for tomorrow's super stock market leader, let me tell you about a few of the traps and pitfalls.

Watch Out for Misleading Reports of Earnings

Have you ever read a corporation's quarterly earnings report that stated, "We had a terrible first three months. Prospects for our company are turning down due to inefficiencies in the home office. Our competition just came out with a better product, which will adversely affect our sales. Furthermore, we are losing our shirt on the new midwestern operation, which was a real blunder on management's part."

No! Here's what you see. "Greatshakes Corporation reports record sales of $7.2 million versus $6 million (+ 20%) for the quarter ended March 31." If you own their stock, this is wonderful news. You certainly are not going to be disappointed. You think this is a fine company (otherwise you wouldn't own its stock), and the report confirms your thinking.

Is this record-breaking sales announcement a good report? Let's suppose the company also had record earnings of $2.10 per share of stock for the quarter. Is it even better now?

What if the $2.10 was versus $2 (+ 5%) per share in the same quarter the previous year? Why were sales up 20% and earnings ahead only 5%? Something might be wrong—maybe the company's profit margins are crumbling. At any rate, if you own the stock, you should be concerned and evaluate the situation closely to see why the earnings increased only 5%.

Most investors are impressed with what they read, and companies love to put their best foot forward. Even though this corporation may have had all-time record sales, up 20%, it didn't mean much. You must be able to see through slanted published presentations if you want the vital facts.

The key factor for the winning investor must always be **how much the current quarter's earnings are up in percentage terms from the same quarter the year before!**

Let's say your company discloses that sales climbed 10% and net income advanced 12%. This sounds good, but you shouldn't be concerned with the company's total net income. You don't own the whole organization. You own shares of stock in the corporation. Perhaps the company issued additional shares or there was other dilution of the common stock. Just because sales and total net income for the company were up, the report still may not be favorable. Maybe earnings per share of common stock inched up only 2 or 3%.

Break Down Six or Nine Month Earnings into Quarterly Percentage Changes

Suppose your company announces that earnings for the six months that ended June 30 were $2.50 per share versus $2 for the same period a year earlier (+ 25%). Your "pet" stock must be in great shape. You couldn't ask for better results—or could you?

Beware. The company reported earnings for six months. What did the stock earn in the last quarter, the three months ended in June?

Maybe in the first quarter ended in March the stock earned $1.60 per share versus $1 (+ 60%). What does this leave for the last quarter ended June 30? Ninety cents versus one dollar. This is a terrible report, even though the way it was presented to you sounded terrific.

If you own common stock in a company whose earnings had been up 60% and they came out with a statement of $.90 versus $1 (down 10%), you had better wake up. The outfit might be deteriorating.

You can't always assume that because an earnings report appears to be rosy, everything is fine. You have to look deeper and not accept the reassuring manner of corporate news releases reported in your favorite newspaper.

Many times, earnings declarations are published for the most recent nine months. This tells you nothing, and all too often it masks serious weakness in the numbers that really count. The first quarter may have been up 30%, the second quarter up 10%, and the last quarter off 10%. By always breaking down the figures to show the quarter-by-quarter earnings, you will be able to see a completely different picture and trend.

Omit a Company's One-Time Extraordinary Gains

The last important trap the winning investor should sidestep is being influenced by nonrecurring profits.

If an organization that manufactures computers reports earnings for the last quarter that include profits from the sale of real estate or a plant, for example, that part of the earnings should be subtracted from the report. Those are one-time, nonrecurring earnings and are not representative of the true, ongoing profitability of corporate operations. Ignore them.

Set a Minimum Level for Current Earnings Increases

As a general guide for new or experienced investors, I would suggest you *not* buy any stock that doesn't show earnings per share up *at least 18 or 20%* in the most recent quarter versus the same quarter the year before. Many successful money-makers use 25 or 30% as their minimum earnings parameter. And make sure you calculate the percentage change; don't guess or assume. You will be even safer if you insist the last two quarters each show a significant percentage increase in earnings from year-ago quarters.

During bull markets, I prefer to concentrate my buying in equities (common stocks) that show powerful current earnings leaping 40 or 50% or more. Why not buy the very best merchandise available?

If you want to further sharpen your stock selection process, before you buy, look ahead to the next quarter or two and check the earnings that were reported for those same quarters the previous year. See if the company will be coming up against unusually large or small earnings achieved a year ago.

In some instances, where the unusual year-earlier earnings are not due to seasonal factors (the December quarter is always big for retailers, for example), this procedure may help you anticipate a strong or poor earnings report due ahead in the coming months.

Many individuals and institutions alike buy stocks with earnings down in the most recently reported quarter just because they like a company and think the stock's price is cheap. Usually they accept a story that earnings will rebound strongly in the near future.

While this may be true in some cases (it frequently isn't), the main point is that at any time in the market, you have the choice of investing in at least 5000 or more stocks. You don't have to accept promises of something that may never occur when alternative investments are actually showing current earnings advancing strongly.

The Debate on Overemphasis of Current Earnings

Recently it has been noted that Japanese firms concentrate more on longer-term profits rather than on trying to maximize current earnings per share.

This is a sound concept and one the better-managed organizations in the United States (a minority of companies) also follow. That is how well-managed entities create colossal quarterly earnings increases, by spending several years on research, developing superior new products and cutting costs.

But don't be confused. You as an individual investor can afford to wait until the point in time when a company positively proves to you its efforts have been successful and are starting to actually show real earnings increases.

Requiring that current quarterly earnings be up a hefty amount is