FINDING #1 STOCKS

SCREENING, BACKTESTING, AND TIME-PROVEN STRATEGIES

KEVIN MATRAS

Chapter 1

The Importance of Screening and Backtesting

One of the reasons why so many people are not seeing the kinds of returns they hope to see in their stock investments is because they don't know which stocks to buy and sell. They find themselves invested in mediocre stocks because they don't know of anything better to get into. For some, their knowledge or "universe" of familiar stocks is relatively small, and this limits their opportunity to invest in better ones.

Worse, when they finally do pick a new stock (likely an all too familiar one) and that doesn't work out as planned either, it discourages them even more from going out and finding others.

But it doesn't have to be that way.

Why Should I Use a Stock Screener?

With over 10,000 stocks out there to pick and choose from, we all need a way to find the good ones.

Aside from buying stocks that are talked about on TV, written about in the newspaper, or touted on the Internet (not to mention tips from a friend)—how else are you going to find stocks that meet certain characteristics?

Even if you don't use a screener now, most people still do their own screening in one way or another. You may hear that a stock has a certain growth rate or a certain P/E ratio or sales surprise or whatever. You then find yourself listening for or reading about or surfing the Internet for stocks that meet this criteria. Well, if you want to find stocks that meet certain criteria, certain characteristics, you can find them quickly and easily with a stock screener.

But just because you've narrowed down 10,000 stocks to only a handful, doesn't necessarily mean that you've picked the best stocks on the planet. You might have picked the worst ones.

Just because you've narrowed down 10,000 stocks to only a handful, doesn't necessarily mean that you've picked the best stocks on the planet. You might have picked the worst ones.

But how will you know?

Backtesting!

Once you've created a screen, you can then backtest it to see how good or bad your screening strategy has performed in the past.

In other words, does your screening strategy generally find stocks that go up once they've been identified? Or does your screen generally find stocks that get buried once they've been identified?

This is good stuff to know. With backtesting, you can see how successful your stock picking strategy has performed in the past so you'll have a better idea as to what your probability of success will be now and in the future.

Of course, past performance is no guarantee of future results, but what else do you have to go by? Think about it. If you saw that a stock picking strategy did nothing but lose money year after year, trade after trade, stock after stock, over and over again, there's no way you'd want to trade that strategy or use that screen to pick stocks.

Why?

Because it's proven that it picks bad stocks. Sure, it may turn around and start picking winners all of a sudden, but it may also continue to pick

losing stocks the way it always has. On the other hand, what if you saw that a strategy did great year after year, period after period, over and over again? You would, of course, want to trade that strategy.

Why?

Because it's proven to be a profitable stock picking strategy. And while it may start picking losers all of a sudden (now that you're using it—right?), it may also continue to pick winning stocks just like it had been doing over and over before.

Now, keep in mind that a screening and backtesting program isn't a box of magic, but it's a great way to see what works and what doesn't before you put your money at risk.

Backtesting is a great way to see what works and what doesn't before you put your money at risk.

Unfortunately, too many people have no idea how to pick the right stocks. And this often leads people into staying in the wrong stocks too long or never getting into new stocks altogether.

I remember I had a conversation with a friend several years ago who was stuck in a losing stock:

Me: Why are you still in that stock if it keeps going down, losing you money?

Friend: I don't think it'll go much lower from here.

Me: Did you think it would go this low when you first bought it?

Friend: No.

Me: Do you think it will go up from here?

Friend: Probably not right away. It may still go down some more.

Me: You know, there are plenty of stocks going straight up. Why don't you get out of that one that keeps going down and losing you money and get into a better one?

Friend: I don't know of any better stocks to get into.

Me: What if you did know of a better stock to get into, would you do it?

Friend: Yeah! (Pause) But I'm not sure *how* to find better stocks.

And that last comment said it all. He was in losing stocks because he didn't know how to pick better ones. But if he had a proven profitable stock picking strategy, he could.

Don't get me wrong. Just because you have a great strategy for picking winning stocks, it isn't going to preclude you from ever having another losing trade. On the contrary, even some of the best strategies "only" have win ratios of 65% or 70% or 80%—not 100%.

But if your stock picking strategy picks winners far more often than it picks losers, you can quickly cut your losses once you find yourself in a losing trade and feel confident that your next pick will have a high probability of succeeding.

If your strategy picks winners far more often than losers, you can feel confident that your next pick will have a high probability of success.

And that's why someone should use a screener and a backtester to pick stocks.

Chapter 2

Identifying What Kind of Trader You Are

Now that we know the importance of screening and backtesting, the next step is to identify what kind of trader you are (or want to be). This will make sure that you're getting into the right kinds of strategies and stocks *for you.*

The first step in identifying what kind of trader you are is to ask yourself some questions. What's interesting is that, often when I ask someone what kind of trader they are, they'll immediately say they're a growth trader or a value investor, and so forth. But when they stop and review the answers they've given themselves, it turns out they're completely different than the kind of trader they thought they were.

Here are three great questions to ask yourself to help you identify what kind of trader you are.

Question 1: What Kinds of Stocks Do You Want to Invest In?

This first question is intentionally broad, but it's a great place to start. Once you've indentified the kinds of stocks you'd like to trade, you can then learn

about what style of trade these types of stocks fall into. And knowing what types of stocks you're looking for will make the process of finding them that much easier. So first things first.

Are you looking for:

- High flyers and fast movers?
- Stocks with big earnings momentum or aggressive growth?
- Maybe solid companies with dependable growth?
- Perhaps mature companies with income producing dividends?
- Or deeply discounted or undervalued stocks?

There are a lot of different types of stocks to choose from. I've listed just a few. But do your best at answering this first main question. Once you're done, then it's time to dig a little deeper.

Question 2: What Characteristics Do You Want Your Stocks to Have?

This is an extension of Question 1, but now we're getting into some of the details. And it's these details that help distinguish one type of stock from another. Go through the list below and expand on the characteristics as much as you'd like. This is actually a fun step and can be quite interesting because oftentimes some of the details people identify with are quite different than the types of stocks they identified as wanting to trade.

Ask yourself which characteristics are most important to you:

- Low valuations (e.g., low P/E ratios, or price to sales ratios, etc.)?
- Great management (as reflected by a strong ROE)?
- Stocks making new highs?
- Maybe big earnings growth or earnings surprises?
- Companies with a particular ranking (like the Zacks Rank)?

The number of possible characteristics is virtually endless. But there's no need to list them all. The characteristics you've probably already thought of are enough to better understand what kinds of stocks are right for you. Although, you might want to go back to the first question to see how closely aligned your answers to both 1 and 2 are to each other. Whether your answers

are in perfect synch (good for you) or all over the map (don't worry about it for now), this is all part of the identification phase. And so is the next question.

Question 3: What Do You Want Your Stocks to Do for You?

Of course you want your stocks to make money. But how? How do you expect them to perform? Over what time period? And by how much? Answer this question and the ones that go along with it to better identify what type of trader you are.

- Are you looking to make fast money by getting in and getting out quickly?
- Or are you interested in finding long-term core holdings?
- Are you looking for stocks to generate income?
- Or would you prefer a medium-term trading strategy to actively pick stocks and grow a portfolio?

These are great questions to ask yourself. And there are other great questions as well. What are your investing goals? Have you ever achieved any of them? (If not, could it be that you've been focusing on the wrong stocks to achieve those goals?) What is your time horizon? What are you even trying to make this money for? Is this for fun? For your retirement? For your kid's education? In other words, what are you investing for?

You may be thinking that figuring out what kind of trader you are is no big deal. But it is. And it's absolutely imperative that you do. Why? Because if you find yourself trading a strategy or getting into stocks that are not in alignment with who you are and what you want, you're going to drop that strategy (no matter how good it's proven to work); you're going to drop that strategy the very moment it hits a rough patch.

Identifying the type of trader you are and what kinds of stocks you want to get into is a critical step to trading success.

You may also want to reflect on your current holdings and ask yourself if your answers are consistent with what's in your portfolio. Are your stocks consistent with who you are as a trader? Are they consistent with the kinds of stocks you want to be in? If they are not, you need to make a change.

Chapter 3

Defining the Basic Trading Styles

Once you've taken stock of yourself (no pun intended) and have a better understanding of what kinds of stocks you want to be in, the next step is to identify what trading style fits you the best. Each trading style has a unique set of characteristics that sets it apart from the others.

To make it easier to identify what kind of trader you are, let's define the four main fundamental trading styles: Momentum, Aggressive Growth, Value, and Growth and Income. And there's no need to worry if you don't fit perfectly into just one style. Many people have parts of each style in them, including myself. But it's still important to accurately identify what the different trading styles are and what stocks are best suited for each one.

Momentum Style

Momentum traders and investors look to take advantage of upward trends or downward trends in a stock's price or earnings. We've all heard the old adage, "the trend is your friend." And who doesn't like riding a trend?

Momentum style traders believe that these stocks will continue to head in the same direction because of the momentum that is already behind them. Momentum traders often fall into two categories, those who focus on price momentum screens and those who focus on earnings momentum screens.

Price Momentum

If you're looking at a *price momentum* screen, you're going to be looking at stocks that have been continuously going up, day after day, week after week, and maybe even several months in a row.

These are the kinds of stocks a momentum trader is after. And this, of course, also includes stocks making new 52-week highs. I point this out specifically because some people hate getting into stocks making new highs. We'll talk later about why I think that is. But it's important to know that there's a lot of evidence that shows stocks making new highs have a tendency of making even higher highs.

If you're uncomfortable buying stocks making new highs, that's okay. But the Momentum style of trade is probably not for you.

I should also mention that this style of trade will likely carry with it a higher degree of volatility, which is the rate at which a stock moves up or down. Although, the Momentum trader expects the gains made because of this to make it all worthwhile.

Earnings Momentum

The same momentum concept is true with earnings. If you're an *earnings momentum* trader, you're looking for companies whose earnings growth rate continues to accelerate, quarter after quarter after quarter. These are the kinds of companies that are going to fall into this category.

Another thing to keep in mind is that it is quite common for price momentum companies and earnings momentum companies to trade at higher valuations—like a higher P/E ratio, for example. Why? Because investors witnessing this momentum are usually willing to pay up for these stocks for fear that they'll get even more "expensive" if they wait.

It should also come as no surprise that these two types of momentum (price and earnings) will often go hand in hand. Companies with earnings momentum attract buyers. And more buying equals more demand, which in turn increases stock prices.

Aggressive Growth Style

Aggressive Growth traders are primarily focused on stocks with aggressive earnings growth or revenue growth (or at least the potential for aggressive growth). And you can expect volatility in this style of trading as well.

You'll often find smaller-cap stocks in this category because smaller-cap stocks are typically newer companies that are in the early part of their growth cycle. Of course, they don't all have to be small-cap stocks. They could be mid-cap stocks or even large-caps, too. For example, if there's a company that has been in existence for a while and they have a new product or service and they're lighting sales on fire, you may see some spectacular growth rates allowing that company to work its way into an aggressive growth style screen.

However, a word of caution: It's not as easy as just simply looking for stocks that have the highest growth rates. So don't go out and start looking for stocks with a 500% or 1,000% growth rate. While there will definitely be companies out there like that who do well, my studies have shown that those kinds of companies will typically underperform. In fact, oftentimes you'll see the companies with the highest growth rates perform almost as poorly as those with the lowest growth rates.

Why is that? It's because those levels of growth are unsustainable. And the stocks are often priced for perfection.

For example, let's say company XYZ just reported earnings of 1 cent. Now analysts are projecting next quarter's earnings to be 6 cents, which is a 500% growth rate. Weeks go by, and for whatever reason the analysts now revise their earnings estimates down to 5 cents a share. So, while 5 cents is still a 400% projected growth rate, it's also 100 points less than what was first expected for a –16% earnings estimate revision.

And if you're the person who just got into that stock the day before, you'll likely be scratching your head wondering why on earth a stock with a 400% growth rate is getting pounded. That's why.

Aggressive growth stocks are some of the most exciting picks out there. And they can be extremely rewarding. Just be sure to use your head when looking for those kinds of companies. And pay attention to the earnings estimate revisions. One of the best ways to find aggressive growth stocks is to screen for companies with growth rates that are meaningfully above the median for their industry, but not necessarily crazy high above it.

Value Style

Value investors and traders favor good stocks at great prices over great stocks at good prices.

This does not mean they have to be cheap stocks in price, though. The key is the belief that they're undervalued. That they are, for some reason, trading under what their true value or potential really is, and the value investor hopes to get in before the market "discovers" this and moves higher.

There could be many reasons why these stocks are being discounted by the market. Maybe they had disappointed in previous quarters and everybody just kind of lost interest. Maybe they don't have the kinds of exciting growth rates that can attract investor interest like an aggressive growth stock can. Maybe they're just in a boring industry. Who knows?

But the value investor is trying to find these kinds of stocks that have been ignored by the market. And normally you'll see these kinds of stocks showing up in your screens by looking at their valuations.

Understand though, the value investor will typically need to have a longer time horizon because, if that stock has been undervalued (i.e., "ignored" for a while), it may take a bit of time before that stock gets noticed and makes a move. So don't think that just because it showed up on your screen that it's immediately going to skyrocket. You may need a longer holding period for the rest of the market to catch up and reprice that company higher.

But keep your eyes out for their earnings estimates. There usually needs to be a catalyst for these unloved, underappreciated, overlooked companies to move. And I can think of no better way than to look at a series of upward earnings estimate revisions to put these stocks on someone's radar screen and to have them sit up and take notice.

Growth and Income Style

Growth and Income investors are looking for good companies with solid revenue that pay a good dividend.

Oftentimes these are more mature, larger-cap companies that generate solid revenue. These companies then pass that revenue along to their shareholders in the form of a dividend.

These are companies that may not have the kinds of spectacular growth rates like some of the younger or smaller companies have (or like they themselves had when they were younger and earlier in their growth cycle).

But it's not as if they're bad companies. They may be great companies, generating huge amounts of cash, but, because of their size, they may not have the growth opportunities they once had.

For example, let's say there was a small-cap company that does $100 million dollars in sales. And someone comes up with a great idea that will increase sales by an additional $100 million dollars. That's great news. And that company is now looking at a 100% growth rate. But apply that to a mid-cap company that does $1 billion in sales, and that $100 million dollar increase is now only a 10% increase in sales. Now apply that same $100 million dollar increase to a company that does $10 billion in sales, and that's only a 1% increase.

Simply put, for some companies, the law of big numbers makes it harder to grow at the torrent pace that a younger and smaller company is capable of. So instead of investing all of their earnings back into the company, they reward their shareholders by paying out a portion of their profits in the form of a dividend.

Like the value investor, the growth and income investors will also have a longer time horizon, especially since they'll want to hang onto their stocks long enough to receive the dividend. Usually, this kind of investor is looking to hold onto these companies for three to six to 12 months or longer.

"All Style" Style

Another style, which I alluded to at the top, that is equally as popular, or maybe even more so, is a combination style or "All Style" style as I like to call it. (It reminds me of "All-Star.")

This combines the best of some of the different trading styles or even all of the different trading styles into one screen. And this is the category that probably most people will fall into. They have a little bit of everything in their screen.

But don't think that when you're building your screens, you're going to find companies with a 100% growth rate that are also paying a 10% dividend. Those things are on the opposite ends of the spectrum.

Also, if you're looking at a value company—remember, these are the ones that are overlooked or ignored—don't expect to find many deep value stocks that are up 30%, 40%, or 50% over the course of the last few weeks, because that's the antithesis of being overlooked. Everybody's now on that stock.

I'm sure there are some value stocks out there like that, but those are probably the ones the value guy found several months ago that are now

paying off. And those stocks are no longer trading at the same value as they once were when he first got into them.

Smartly combining the best of one or more styles that complement one another can make for a powerful strategy.

Technical Analysis

No discussion on trading styles would be complete without the inclusion of Technical Analysis (TA).

My favorite brand of technical analysis is chart pattern recognition. In addition to that, I also use moving averages and the relative strength index (RSI) oscillator among others.

Technical analysis is really just a study of price movement and volume and all the different ways of displaying and measuring that. I'll go into more detail on chart pattern analysis later in the book, but technical analysis can be applied to any and all base styles of trade.

Momentum style traders will typically monitor price trends and moving averages as well as volume changes and more—all forms of technical analysis. This is also true for Aggressive Growth traders as well. Value traders and Growth and Income traders also look at technical analysis, including charts and price patterns, in an effort to determine when a stock will move and in what direction.

Whether you consider yourself a fundamental trader or technical trader, each style has something to offer. In fact, even the most die-hard of technicians, while espousing the virtues of technical analysis, will still look at the fundamentals. And nowadays, even the strictest of fundamental traders will at least glance at a chart before getting in.

Winning in Style

Think about the last car you bought. Once you decided what kind of car you wanted, you probably saw them everywhere. They didn't just magically appear on the road. They were always there. You just became aware of them.

The same can be said for picking stocks. Once you've identified what kind of trader you are and the style of trade that fits you the best, it becomes easier to find stocks with those characteristics. When you know what you're looking for, it becomes easier to find. And the sooner you start finding the right stocks for your trading style, the more money you'll make.

Chapter 4

Trading the Zacks Rank

One of the simplest and one of the best trading strategies is to simply buy the stocks that have a Zacks Rank #1 and sell them when they're no longer Ranked a #1 (which means a 2, 3, 4, or 5). Since 1988, this strategy has beaten the S&P in 20 out of the last 22 years.

The Zacks Rank versus the Market

The strategy of buying the Zacks #1 Ranked stocks and selling them a month later if they're no longer Ranked a #1 has shown an average annual gross return of 27.27% a year.[1] This is in stark contrast to the S&P 500's 8.86% average return.

Take a look at the returns and you can see that the Zacks Rank has increased by over three times that of the S&P. (See Table 4.1.)

But understand, if you're able to do this in a repeatable way, over and over again, that can add up to a lot more than just three times the S&P.

In fact, assuming you could realize the returns for each year as shown, the following chart illustrates how a portfolio could have grown in value. (Note: the compounded returns displayed do not include brokerage commissions and fees or potential price impacts due to trade execution or bid/ask spreads.) (See Figure 4.1.)

[1] For a complete explanation of how the performance of the Zacks Rank is calculated, please refer to page 285.

TABLE 4.1 Zacks Rank Performance Summary (Monthly Rebalancing)

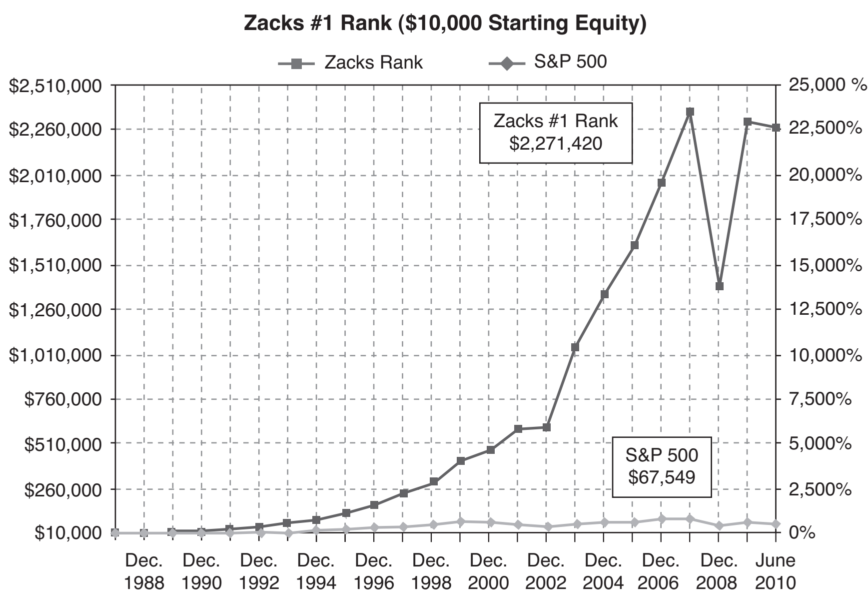
Year	*#1 Rank*	*#2 Rank*	*#3 Rank*	*#4 Rank*	*#5 Rank*	*S&P 500*
1988	37.46%	29.69%	20.79%	19.13%	18.39%	16.20%
1989	36.09%	26.84%	15.85%	9.55%	–5.10%	31.70%
1990	–2.97%	–13.69%	–21.32%	–23.85%	–34.71%	–3.10%
1991	79.79%	56.80%	45.98%	36.60%	34.35%	30.40%
1992	40.65%	29.63%	18.04%	12.24%	17.31%	7.51%
1993	44.41%	26.86%	14.78%	8.59%	9.54%	10.07%
1994	14.34%	5.15%	–3.56%	–11.14%	–10.90%	0.59%
1995	54.99%	46.84%	30.63%	17.35%	9.11%	36.31%
1996	40.93%	28.60%	16.07%	7.71%	8.02%	22.36%
1997	43.91%	33.87%	22.93%	10.17%	3.05%	33.25%
1998	19.52%	12.92%	–3.47%	–8.77%	–14.84%	28.57%
1999	45.92%	35.53%	31.02%	18.46%	17.69%	21.03%
2000	14.31%	–1.47%	–17.75%	–19.52%	–3.95%	–9.10%
2001	24.27%	11.70%	14.09%	17.93%	20.20%	–11.88%
2002	1.22%	–14.51%	–19.39%	–23.50%	–17.59%	–22.10%
2003	74.74%	71.02%	66.69%	57.34%	55.99%	28.69%
2004	28.79%	23.26%	18.51%	11.92%	16.63%	10.87%
2005	17.97%	12.01%	6.54%	–1.31%	–5.08%	4.90%
2006	23.69%	26.63%	18.09%	15.17%	16.88%	15.80%
2007	19.91%	5.42%	–4.34%	–13.06%	–23.90%	5.49%
2008	–41.13%	–43.48%	–48.70%	–45.75%	–50.95%	–37.00%
2009	66.87%	82.46%	78.42%	59.91%	49.18%	26.46%
2010*	–1.71%	2.87%	–1.50%	–1.89%	–0.56%	–6.64%
Annual Average	27.27%	18.65%	9.70%	3.93%	1.70%	8.86%

*2010 returns are for the period of Jan. 1 to June 30, 2010.

What's interesting is that we've all heard people say that becoming a better investor can change your life. While it's a great catch phrase, I don't think anybody really stops to think about it or let alone believes it. But it's true. Becoming a better investor can change your life. Just ask the guy who's going to retire this year on $67,000 vs. the guy who's going to retire on $2.2 million and tell me that guy with $2.2 million isn't living a different life than the guy with $67,000. Becoming a better trader *can* change your life.

As you can see, implementing ways to consistently beat the market can quickly add up. Of course, there are over 200 Zacks #1 Ranked stocks at any given time, so narrowing them down to a smaller, more manageable list or portfolio is the next step.

FIGURE 4.1 Zacks #1 Rank Compounded Performance



See page 285 for a complete explanation of how these compounded returns are calculated.

But before we go any further, in order to fully understand why the Zacks Rank works so well, it's important to understand what the Zacks Rank is and how it's calculated.

About Len Zacks

The Zacks Rank was created by Leonard Zacks, the CEO and co-founder with his brother Ben Zacks, of Zacks Investment Research. Len, who has a PhD from MIT, spent many years on Wall Street testing statistical models to help uncover ways to beat the market. Len's research led to a breakthrough discovery: "Earnings estimate revisions are the most powerful force impacting stock prices."

"Earnings estimate revisions are the most powerful force impacting stock prices."—Ben and Len Zacks

His findings were first published in 1979 in the *Financial Analysts Journal* and entitled "EPS Forecasts–Accuracy Is Not Enough". From this

seminal work emerged the now famous Zacks Rank stock picking system, which harnesses the power of earnings estimate revisions. And so began a long tradition of innovations by his now famous firm, Zacks Investment Research.

Len may be a PhD, but you don't have to be one in order to take advantage of the Zacks Rank.

Calculating the Zacks Rank

The foundation of the Zacks Rank has to do with earnings estimate revisions. Stocks with rising estimates, as a group, have outperformed the S&P 500 year after year. And stocks with falling estimates have underperformed the S&P 500 year after year.

This means that the stocks most likely to outperform are the ones whose earnings estimates are being raised. And the stocks most likely to underperform are the ones whose earnings estimates are being lowered.

Zacks (through the Zacks Rank), has made the process of identifying stocks with changing earnings estimates easy and very profitable. Since 1978, Zacks has been compiling and analyzing brokerage research for both institutional investors and individual investors.

Today, Zacks processes this information from roughly 3,000 analysts from over 150 different brokerage firms. At any given point and time, they're monitoring well over 200,000 earnings estimates and other related data looking for any change. The ability to gather, analyze, and distribute this information on a timely basis makes Zacks' research among the most widely used investment research on the Web.

Our performance, of course, is another reason. As I mentioned earlier, a portfolio constructed of just the Zacks #1 Ranked stocks has generated an average annual return of 27.3%.

Even during the bear market of 2000 to 2002, this strategy generated positive returns (see Table 4.2). In 2000, the S&P lost –9.10%, while the Zacks #1s picked up 14.31%. In 2001, the S&P had another tough year, closing down –11.88%, while the Zacks #1s gained a spectacular 24.27%. And in 2002, the S&P had its worst year of that three-year period, losing another –22.10%, whereas the Zacks #1 Ranked stocks actually added to their gains, picking up an additional 1.22%.

The compounded returns of the Zacks #1 Ranked stocks during that three-year bear period was 43.79%. The S&P 500 during that same bear move was –37.60%.

TABLE 4.2 Zacks #1 Rank, 2000–2002

Year	*#1 Rank*	*S&P 500*	*#1 vs. S&P*
2000	14.31%	–9.10%	+23.41
2001	24.27%	–11.88%	+36.15
2002	1.22%	–22.10%	+23.32

What about the worst bear market in recent history and the second-worst bear market of all time? (The period 2000 through 2002 only ranks as the seventh-worst bear market.) I'm talking about the financial crisis of 2007 through the first quarter of 2009 when the S&P 500 lost −57.7% in a year and a half.

By the end of 2007, the market was starting to show its cracks, but the S&P managed to hold onto a 5.49% gain, while the Zacks #1s were up 19.91%. The year 2008 was a different story as there was virtually no place to hide. The S&P 500 was down −37.00% while the Zacks #1s lost −41.13%. The worst performance in the history of the Zacks Rank and only the second time ever that the Zacks #1s underperformed the market. However, with over a 20-year track record at that point, those who remained confident that the Zacks Rank would soon outperform the market once again were well rewarded. In 2009, after the market hit its lows in March, the S&P rallied for a 26.46% gain on the year, but the Zacks #1s gained more than 2.5 times that with a 66.87% gain (see Table 4.3).

TABLE 4.3 Zacks #1 Rank, 2007–2009

Year	*#1 Rank*	*S&P 500*	*#1 vs. S&P*
2007	19.91%	5.49%	+14.42
2008	–41.13%	–37.00%	–4.13
2009	66.87%	26.46%	+40.41

The Zacks #1 Ranked stocks from the beginning of the collapse in 2007, through the worst of 2008, and into the subsequent rebound of 2009, generated a total compounded return of 17.80% vs. the S&P's −15.96%.

In fact, in any one of those bear market periods, had someone been on the negative side of that equation, that could have forced some people to postpone their retirement or, worse, changed how they planned on living out their retirement years altogether.

Of course, if you were on the winning side, what a great send-off.

What the Rankings Mean

The Zacks Rank is a proprietary quantitative model that looks at changes and trends in earnings estimate revisions and earnings surprises. We then use this information to classify stocks into five groups:

Zacks Rank #1—Strong Buy

Zacks Rank #2—Buy

Zacks Rank #3—Hold

Zacks Rank #4—Sell

Zacks Rank #5—Strong Sell

But don't confuse this with the average broker rating, as it couldn't be more different.

First, the Zacks Rank is proportionately applied to the approximate 4,400 stocks for which sell-side analyst estimates are available. By proportionate, I mean only the top 5% of the stocks assigned a Zacks Rank can receive the coveted position of a Zacks #1 Rank—Strong Buy. It's also important to know, and maybe even more important, that the same number of stocks (5%) are assigned a Zacks #5 Ranking, which is a Strong Sell (see Table 4.4).

TABLE 4.4 Zacks Rank, Distribution

Zacks Rank	*Zacks Rank Universe (Approximate)*	*Recommendation*
1	5%	Strong Buy
2	15%	Buy
3	60%	Hold
4	15%	Sell
5	5%	Strong Sell

This equality between Strong Buy and Strong Sell recommendations makes the Zacks Rank a much more reliable indicator than your typical brokerage recommendations, which are significantly biased toward "Buy" ratings with a terrible reluctance to say "Sell."

So what do these recommendations mean?

- Zacks Rank #1 or Strong Buy means it should outperform the market the most, i.e., more than the other Ranks. (By "market" we

are referring to the S&P 500, which is one of the most commonly used benchmarks.)

- Zacks Rank #2 or Buy means it should outperform the market.
- Zacks Rank #3 or Hold means it should perform in line with the market.

Let me clarify what a Hold recommendation is not. Some people think that a Hold means that if they are in the stock, they are supposed to hold onto it. Or if they're not in it yet, they're supposed to hold off from buying it. That is not what a Hold recommendation means.

A Hold recommendation very simply means there is no compelling reason, one way or the other, for the stock to underperform or outperform the market in any meaningful way. It simply means it should perform in line with the market.

- Zacks Rank #4 or Sell means it should underperform the market.
- Zacks Rank #5 or Strong Sell means it should underperform the market the most.

As Table 4.5 shows, the Zacks Ranks are all performing on target. The Strong Buys have outperformed the market the most. The Buys outperformed the market. The Holds performed in line with the market. The Sells underperformed the market. And the Strong Sells underperformed the market the most.

TABLE 4.5 Zacks Rank, Meaning and Performance

Zacks Rank	*Recommendation*	*Meaning*	*Average Annual Return*
1	Strong Buy	Outperform the market (the most)	27.27%
2	Buy	Outperform the market	18.65%
3	Hold	Market perform	9.70%
4	Sell	Underperform the market	3.93%
5	Strong Sell	Underperform the market (the most)	1.70%

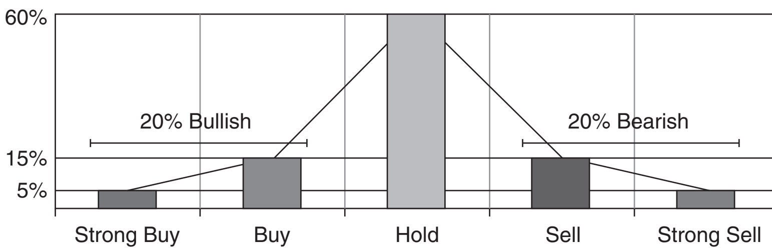
(1988–6/2010)
Average annual return for the S&P 500: 8.86%.

As you can see from the following list, the entire assignment of the Zacks Rank is like a bell curve—an equal number of buys and sells with a larger number of holds in the middle:

- 5% of the stocks are Ranked a #1 or Strong Buy
- 15% are Ranked a #2 or Buy
- 60% are Ranked a #3 or a Hold
- Then going back down the slope: 15% are Ranked a #4 or Sell
- And 5% are Ranked a #5 or Strong Sell

Adding up all of the Strong Buy and Buys: 20% of the ratings are bullish. On the other side of the spectrum, adding up the Sells and Strong Sells: 20% of the ratings are bearish for an even distribution (see Figure 4.2).

FIGURE 4.2 Distribution of Zacks Rank

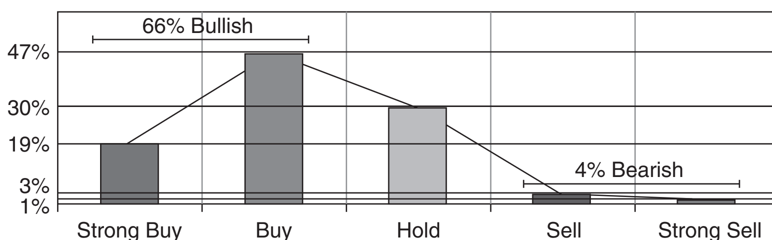


By contrast, if you look at the average broker ratings, as illustrated in the following list, they're quite lopsided:

- 19% of the stocks with a brokerage rating have an average Strong Buy rating
- 47% have a Buy rating
- 30% have a Hold
- 3% have an average broker rating of Sell
- Only 1% have a Strong Sell

Adding up the Strong Buys and Buys of the average broker ratings, a full 66% are bullish whereas the Sells and Strong Sells add up to only 4% being bearish (see Figure 4.3).

FIGURE 4.3 Distribution of Average Broker Ratings



To be fair, the average broker rating can be quite useful, but I believe it's the change in the rating that carries the most value. (More on this later.)

While the analysts aren't that great at making subjective buy and sell predictions, they are good at providing estimates. This is why brokerage companies literally spend billions of dollars a year on analysts to research stocks. They must know something—and they do.

While analysts aren't that great at making subjective buy and sell predictions, they are good at providing estimates.

Analysts are paid in aggregate, over $4 billion a year to analyze stocks. The typical analyst at a brokerage firm will work 80-hour weeks—devoting all his or her time to, at most, maybe 20 companies. And many companies are followed by 5 to 10 analysts or more. One of their main tasks is to determine what a company's earnings will be. This is where they excel. Not in their ratings, but in their earnings estimates.

The reason why earnings matter is because, at the end of the day, earnings give a stock its intrinsic value. And when trying to determine the future direction of a stock's price move, you really need to look at what a company will earn in the future. This is why earnings expectations or earnings estimates are so important.

It's the change in the earnings estimates (earnings estimate revisions) that have proven to be the most important.

Why? Because stocks that receive upward earnings estimate revisions are more likely to receive even more upward revisions in the future. This is true because many analysts will revise their earnings slowly and incrementally. For example, if an analyst raised his earnings estimates last month, he is likely to do it again this month. And other analysts are likely to do the same.

Since stock prices respond to earnings estimate revisions, it's very profitable to buy stocks whose earnings estimates are being raised. By getting into stocks whose earnings estimates are being raised, you're likely getting into companies whose future earnings estimates will be raised as well, potentially influencing stock prices even more. As a result, *stocks receiving upward earnings estimate revisions tend to outperform over the next one to three months.*

Four Factors of the Zacks Rank

So *how* does Zacks use earnings estimates and earnings estimate revisions in the Zacks Rank? The Zacks Rank is calculated from four primary inputs:

Agreement: This is the extent to which all brokerage analysts are revising their earnings estimates in the same direction. The greater the percentage of analysts there are that are revising their estimates higher, the better the score for this component.

For example, if 40% of the analysts are increasing their earnings estimates for a stock whereas only 10% are increasing it for another stock, the higher the percentage of analysts making upward estimate revisions the better.

Magnitude: This is the size of the recent change in the current consensus estimate for the fiscal year and the next fiscal year.

For example; a 5% increase in the earnings estimate revision is better than a 2% earnings estimate revision and will thus get a better score for this component.

Upside: This is the difference between the most accurate estimate as calculated by Zacks and the consensus estimate.

A bigger difference between the most accurate estimate and the consensus estimate is better.

Surprise: The Zacks Rank factors in the last few quarters' earnings per share (EPS) surprise as well.

Since companies with a positive earnings surprise are more likely to surprise again (or miss again, if recently missed), this is looked at too.

Each one of these components is given a raw score and it's recalculated every night. These raw scores are then compiled into what is called the Zacks Rank and are made available to investors every day, helping them beat the market.