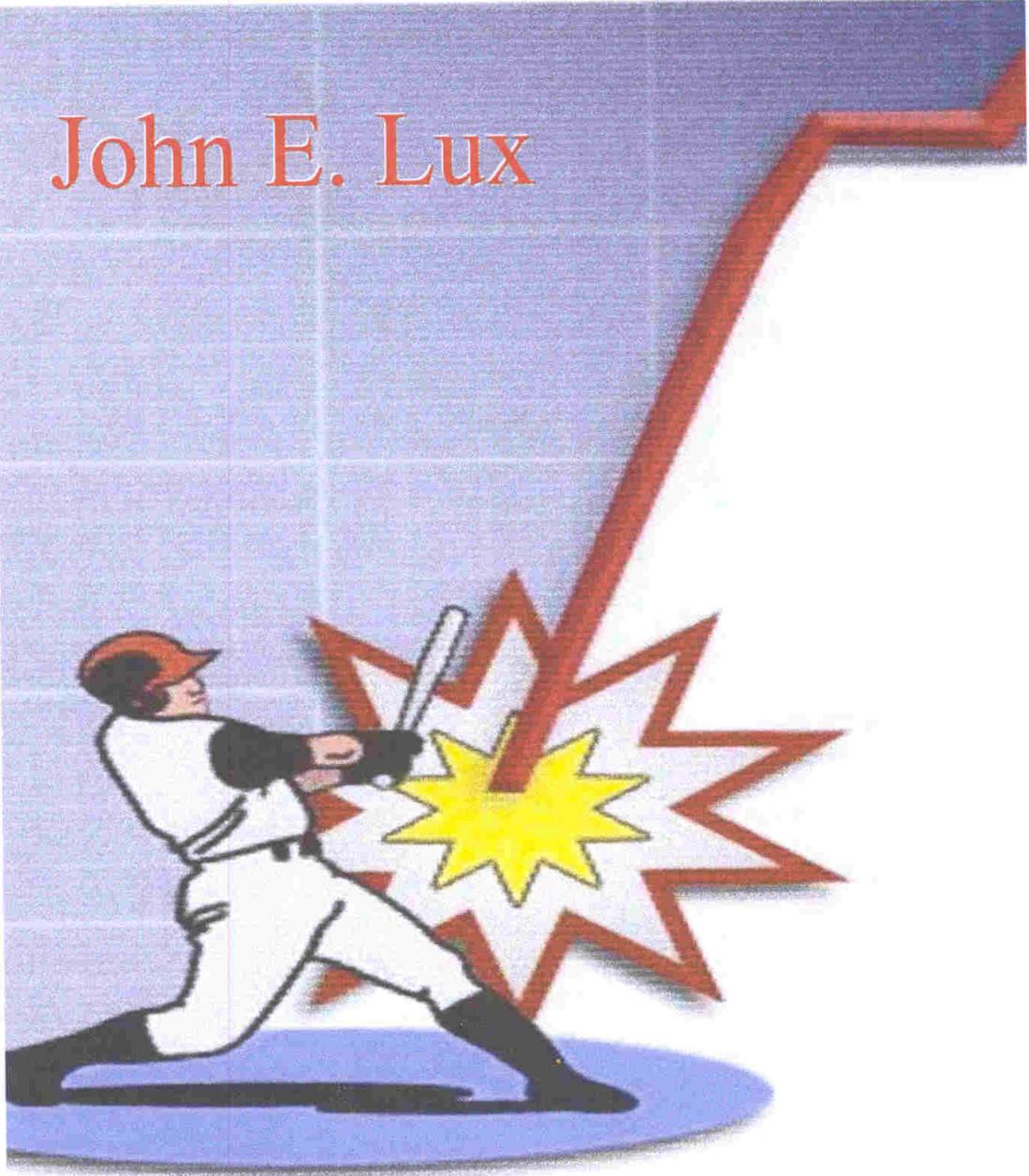




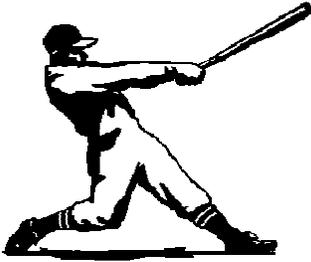
John E. Lux



How to Find a  
Home Run Stock



*How to Find a Home Run Stock by John Lux*



# **How to Find a Home Run Stock**

**By John E. Lux**



*How to Find a Home Run Stock by John Lux*

Congratulations!

With this book, in a few hours you can easily learn to find a "Home Run Stock" that doubles or triples in six months to a year, the "short-term sure thing."

Begin now, keep reading.



*How to Find a Home Run Stock by John Lux*

How to Find a Home Run Stock was written by John E. Lux

Reproduction or translation of any part of this work beyond that permitted by Section 107 or 108 of the 1976 United States Copyright Act without the permission of the copyright owner is unlawful. Requests for permission or further information should be addressed to Permissions Department, Lux Livermore Publishing, P.O. Box 3490, St. Petersburg, Florida 33731.



*How to Find a Home Run Stock by John Lux*





*How to Find a Home Run Stock by John Lux*

## **Disclaimer**

This book contains my opinions and observations. Nothing in this book guarantees a profit to any investor. Past performance is no assurance of future results. Nothing in this book is a representation of any track record of John E. Lux or any related entity. All stocks given are examples for education and are not recommendations or representations of any past, present or future profit. Nothing in this book is investment advice or advice about particular securities. This is a discussion of the theory of investing only.



*How to Find a Home Run Stock by John Lux*

*Dedicated to my father, Dr. John H. Lux.*



## **Contents**

<b>Forward</b>	12
<b>Acknowledgements</b>	13
<b>Introduction</b>	14
The Purpose of this Book	15
What are Home Run Stocks?	16
Who is Writing this Book?	17
How this Book Will Benefit You	19
Reading the Book	20
Questions to Ask	21
Goal of Investing	22
Present v. Future Value	24
<b>Basic Concepts</b>	27
Price	27
Value	29
What is Value?	33
Price v. Value	34



The One Most Important Concept	35
Fundamental Analysis	39
Earnings	41
Asset Value	43
How to Determine Value	47
<b>Understanding Financial Statements</b>	50
Balance Sheet	51
Income Statement	62
Leverage	63
Ratios	66
Range of Ratios	74
Which Ratios to Use	75
Making the Search	77
Interpreting Insider Trading	84
Proprietary Position	86
High P/E	92
Growth Fallacy	93
Asset/Earnings	96



*How to Find a Home Run Stock by John Lux*

<b>Technical Analysis</b>	98
Drawing Trendlines	107
Pattern of Price	110
Example	111
<b>Trading</b>	142
Charting	142
Large Companies	144
Selection	146
How to Buy (and Sell)	148
Short Selling	152
<b>Review</b>	154
<b>Further Reading</b>	155
<b>Summary of the Rules</b>	157
<b>Feedback</b>	158
<b>About Your Author</b>	160
<b>Index</b>	161



*How to Find a Home Run Stock by John Lux*

<b>History</b>	164
<b>Rate Yourself</b>	165
<b>Links</b>	166



*How to Find a Home Run Stock by John Lux*

## **Foreword**

Ten years ago, I wrote the first version of How to Find a Home Run Stock for my clients. The more time goes on, the more this book is essential to investment survival.

Fortunately, advances in technology have made it less time consuming to find a Home Run Stock. I used to spend months ordering and reading hundreds of pounds of annual reports, although I must say I enjoyed it thoroughly. I also ruined my eyesight reading the fine financial print to do the same search that can now be done in seconds for free on the Internet.

I trust that you will be surprised to find that this book is an easy to use guide to huge profits in stocks. I wish you the best of success!

*John E. Lux*



*How to Find a Home Run Stock by John Lux*

## **Acknowledgements**

I suppose I should first acknowledge my father for being such a great role model and teacher.

I would also like to thank another gentleman who had an enormous positive influence on my life, Dr. John A. Myers of Baltimore. His moral guidance was probably even more valuable than his cutting edge nutritional treatments.

I have also to thank the authors and researchers who wrote the thousands of books I read as I researched the market.



*How to Find a Home Run Stock by John Lux*

## **Introduction**

### **Who This Book is For**

This book is for you if you are trying to make money in the market, especially if you have been losing.

This book is written simply so it can be digested by beginners, yet you may be surprised to discover that the principles in the book, and the wisdom conveyed in the book are such that even a professional may find that these concepts explode into new realizations as they hit home.

I believe that these principles are so basic that no matter who you are, you may notice to your delight and gratitude that these thoughts will propel you into investing success for years and years as you discover deeper and deeper meaning in it all.

### **The Book's Approach**

This book lays out the basic principles of investing – value and price movement – in one book. I believe this is unique in the library of investing books. Yet without my guidance on how to apply these principles, you would be lost still.

We then move on to give you rudimentary examples in various stocks. This will allow you to gain some experience. As much as you might desire that knowledge I have, I cannot give you in a single book the in depth-knowledge that trading the markets for over 35 years with a degree in business statistics and law has given me. I can give you a fast start -- and this is it.



*How to Find a Home Run Stock by John Lux*

### **The Purpose of This Book**

The purpose of this book is to take anyone of average intelligence and moderate means and teach him how to achieve superior performance in the stock market.

There are some investors I call semi-professionals. For the semi-professional investors, investing is a serious hobby. The semi-professional investor spends many hours each week studying investments. He has enough business background to have a basic understanding of annual reports and the financial press. The semi-professional investor will benefit from reading this book because he will have a better understanding to the basic, important concepts of investing. He also will benefit from learning the viewpoint of a successful, professional investor.

The amateur investor is the investor who relies on his broker to recommend stocks. The amateur investor is trying to gain an understanding of how to invest and the basic terms of investing. This book will help the amateur investor by giving him the concepts necessary to evaluate the value of his broker's advice. The amateur investor also will benefit by learning the basic concepts of investing.

What category are you in? What do you want to get out of this book?



### **What is a Home Run Stock?**

A "Home Run Stock" is one that doubles or triples in six months to a year—at least.

Here are some of my favorite Home Run Stocks:

Amerford International: bought as low as \$4, recommended in writing at \$7, went to \$48 in 18 months.

Bel Fuse: bought at \$15, sold at \$75 in six weeks.

Braintech: bought as low as \$5, recommended in writing at \$7 ¼, went to \$24 ½ in three months.

Manufactured Homes: bought as low as \$1 7/8, went to \$15 ½ in 18 months.

AMR Corp.: recommended at 1 7/8, went to 17 5/8 in less than one year.

Have I ever recommended stocks that go down? Of course I have! Here are a few home run short sales:

Careercom: sold at \$11, went to 3/8.

Digitech: sold at \$ 6 ½, went to 9/16.

Imreg: recommended at \$10, went to \$1 5/8.

Memory Metals: sold at \$14 ½, covered within 6 weeks at \$7



### **Who is Writing This Book?**

One day I was browsing through the book store looking for books to read. I saw one book with a very interesting title. The cover made me intensely curious to read this book. I felt that the book offered me a chance to acquire important and inside information. Before I purchased the book, I saw a picture of author on the inside back of the book jacket. He was a young and disheveled looking young man. He looked like he belonged in a mental institution. His background was equally distasteful. I did not buy the book because I felt that this person had nothing of value to say to me.

Another time I bought and devoured a scholarly text on commodities trading. This book was full of intricate mathematics. I waded through it, taking notes. Later I found out that during the author's entire career, he had made perhaps \$100,000 by trading. He was, however, a noted expert in the field and advised the clients of a large brokerage firm. I have ceased to be interested in his comments because he has not adequately demonstrated the workability of his ideas.

You need to know that this book is by someone who has made millions of dollars applying the information given in this book. I have managed up to three million in trading dollars. I have been manager of trading for a New York investment banking firm. I have traded up to three hundred stocks at one time. We did not base our trading on making a fraction of a point off large volumes of trades. We based our trading on being right about our stock positions and how their prices would move. Being a stock trader means that you have to evaluate constantly the value of all the stocks you trade. If you do this for years and consistently make money, as I have, you must be doing something right.

Besides following prices, I did my own research. I would take the National Stock Summary, which contains about 40,000 companies, and read it front to back. I did this for many years. This means that I was leaving no stone unturned in finding stocks. I looked at all kinds and sizes of companies. Because I did this year after year, I saw how many companies fared year after year. This was the basis for much of my ideas about how stocks move.

I have tested the information given to you in this book in bull and bear markets, long and short, large companies and small, listed and OTC, in



*How to Find a Home Run Stock by John Lux*

many types of industries. I have used these theories to make real money consistently.

These theories do not work 100%. They work more often than not. They are not the best theories possible. They are the best theories I know. They are not all the information available or even all the information known to me. In my opinion, these concepts are all the basic concepts an investor must have. There is no guarantee that these methods will continue to work. I do not know of any reason why they will not continue to work, but I do know that markets are constantly changing.



### **How This Book Will Benefit You**

Following the incredible successful example of the finest man I know, my father, I wanted to be successful. In fact, I wanted to be even more successful than my father. I wanted to show him that I was worthy of all the help he has given me. This was, and is, my burning desire.

This is a very ambitious goal when your father makes over \$1 million per year as Chairman of the Board of AMETEK, Inc., a Fortune 500 company that has raised its dividend every year for 40 years, has consistent increases in earnings every quarter, and is one of the “Nifty 50” institutional stocks. In short, he is one of the most successful businessmen in the World. One of the companies he ran doubled its stock price every year for the seven years he ran this company.

One day I realized a simple truth. You get out of something what you put into it. This is true of this book and stock picking in general.

When I realized this, I immediately started working 80 to 100 hours per week. A very strange thing happened. I discovered that work was more fun than anything else. I spent many late Saturday nights sitting at my desk on Wall Street. I would read annual reports. Sometimes I would break out in spontaneous laughter when I remembered that my employer was paying me to do what I loved more than anything. I would have paid him gladly. Christmas became a nuisance because I had to spend half a day socializing. Movies were dull in comparison.

Now, it sometime occurs to me that there are those strange few people in the world who do not want to spend every waking moment in their office or the library reading annual reports or business reference books. I am quite sure that they are a small percentage of the population. I sometimes hear about them on the radio when I drive to work in the morning. There are a few, deranged souls who do not get an intense pleasure out of the thought of reading thousand of annual reports. If any of these are reading this book, do not despair. You can use the information in this book to evaluate the work of us normal people.



*How to Find a Home Run Stock by John Lux*

## **How to Read This Book**

Probably the most important thing I ever learned was to question everything and decide for myself as to its truth.

Since my youth, I have looked at practically everything.

This is one of my most important actions. When you read this book, and after you read this book, ask your self many questions. I suggest questions like: does this work, have I seen it work, do I understand this well enough to use it, who uses this, do the people who use this win or fail, how can I use it, does it always work, and if not, why?

There is no end to the questions you can ask. I use in my evaluations in the stock market the maximum return on equity as my test. That is the standard by which I have judged my work.

To jog you into thinking, I have started some of the sections of the book with questions. The questions ask you the basic question answered in that section of the book. If you play the game with me and answer the questions, you will have a chance to look at your current assumptions about investing. You can then compare them with my ideas. This will increase your evaluation of the material.

For example, the section on growth stocks begins with the question, “What makes a stock grow rapidly for years on end?” This section then gives my observations so you may compare your current thinking with mine.

You are invited to write to me about your ideas, too.



## **Some Questions to Ask as You Read This Book**

---

1. *Have I ever seen this work?*
2. *Have I ever seen this not work?*
3. *Under what conditions would this idea work?*
4. *Under what conditions would this idea not work?*
5. *What ideas would give me the best / worst results?*
6. *How could this idea be done better?*
7. *How could I test this idea?*
8. *Who else uses this idea? What are their results with it?*
9. *How can I best apply this?*
10. *Why does it work? How does it work?*
11. *What could be changed about it and it would still work / not work?*
12. *What problems does this idea create / solve?*



### ***The Goal of Investing***

My goal in investing is to produce the largest return on investment possible.

In order to get the most return, we must (1) find a stock that is extremely undervalued, (2) buy it at its low price, and (3) hold it until it becomes very overvalued, and sell it at its high price.

Some say that efforts to make large gains involve large risks. I do not believe this.

First, risk is simply unknown information. If we do not know what the next roll of the dice will bring, there is risk in betting on dice. If we know that the dice are all covered with sevens on each side, we know what the dice will roll.

Second, in the stock market, we can play the odds. If the dice are loaded, and we know it, the odds are that we will win. We can find out what the odds are in the stock market and make a reasonable prediction about one stock. We also can “hedge our bet” by buying many such stocks and know that we have an almost certain chance of making money on the group, even though we might lose on one or two. Thus, the stock market is not gambling. In gambling, in the long run, the house always wins and the player always loses. In the stock market, the informed investor usually wins. In the long run, the informed investor always wins.

The argument that the stock market is gambling is, in my experience, always raised by either (1) an ignorant person, or (2) a person who is cheating another person and wants to give the sucker an acceptable explanation for the loss.

Further, many people complain about what might have been or the one that got away. This is an amusing pastime, but has little place in rational investing. It belongs in the category of entertainment. The truth is that there are about 40,000 stocks traded in the United States alone. If you miss one good opportunity, there are many others available.



*How to Find a Home Run Stock by John Lux*

**Ask yourself now:**

**What is more important, present or future value?**



## **Present v. Future Value**

One school of investing focuses on buying stocks that have good prospects for future earnings. This school of investing tells investors that a stock should be bought because the company has a great future. These people try to predict the future of a company many years in the future.

Other investors focus on predictions of what the economy will do. They start from the “top down” by making predictions about the economy, and using these predictions, determine which industry groups will benefit most from these changes. These investors then select individual companies in these industry groups and buy the companies most likely to benefit.

Both of these approaches have led to major losses. The future is too changeable to predict more than a few years in the future. Predictions about the economy, even from the best economists are often wrong. Economists do not have to make a living trading stocks. They do not need to give useful predictions, only saleable, popular predictions.

The other school of investing studies the present value of a company. If they find that the company now undervalued, based on the value now, without any pie in the sky, or economic forecasts, they buy the stock.

In a study I did a few years ago on short sellers, I noted that there were these two approaches to selecting short sales. I call them the economic prediction approach and the value approach. The study reported repeated, large losses by the economic prediction method and the repeated, consistent profits by the value method.



*How to Find a Home Run Stock by John Lux*

Digitech (DGTC) was a “value short”—it had little or no value. No changes in the economic circumstances were necessary to make the stock virtually worthless—it already was virtually worthless. When I found the stock in 1986, it was selling at \$6 5/8, up from \$0.66. One short we showed it to laughed so hard he almost fell of his chair. The stock subsequently went to \$1.

**Digitech, Inc.**

<b>Year</b>	<b>1985</b>	<b>1986</b>	<b>1987</b>	<b>1988</b>
High	1.13	8.63	8.00	4.88
:Low	0.63	0.66	1.00	1



*How to Find a Home Run Stock by John Lux*

**Again, before we go on, take a minute and think to yourself:**

**How important is price?**

**Are stock prices random?**



## **Basic Concepts**

### **Price**

Price, price per share, is the amount of money you have to pay for a stock, or the amount of money you can get for a stock. The practical definition is that price is what someone will pay for a stock.

In the stock market, price is everything. In the stock market, price is everything, In the stock market, price is everything.

For example, you could buy the stock of a company one day at 2, sell it the next at 4, and the company could file bankruptcy and become worthless the third day. You would then have made a 100% profit on a worthless company.

This is why I say, in the stock market, price is everything.

In 1984, I was running the trading department of a New York investment banking firm. I interviewed a recent MBA graduate from a leading Ivy League business school. He wanted a job as a stock trader. I was eager to learn the latest information from the business school, so I asked him to tell me what he had learned. He replied that he had learned the “random walk” theory that says that changes in stock prices are random and cannot be predicted. I asked how he was going to make money trading stocks if he could not predict stock prices. He did not have an answer to this question. He did not have a job with us.



*How to Find a Home Run Stock by John Lux*

**I keep asking you to think for yourself:**

**What is value?**

**Are stock priced efficiently?**

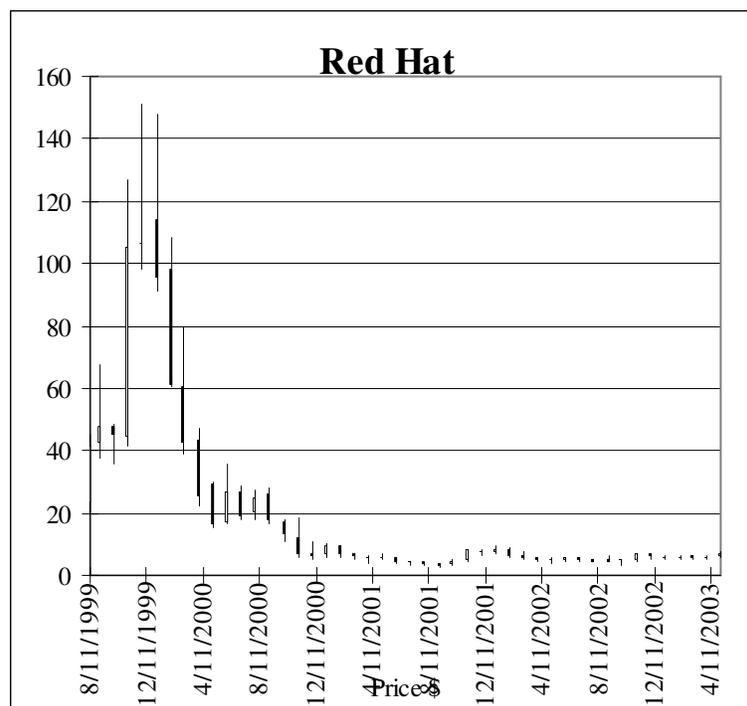


## Value

Value is the fair worth of the stock. Value is what the stock is worth, as opposed to its price.

Some have proposed the “efficient market hypothesis” of the stock market. This theory says that the market always prices all stocks efficiently. If this is true, you cannot find undervalued stocks. If this is true, you should stop reading this book, send it to me, and I will give you a complete refund.

In fact, the price of a stock often is very different from its value. Example: (see chart) Red Hat reached a high of over \$150 before bottoming out at \$3.50.



How did RHAT get to a price about 40 times its subsequent low?



*How to Find a Home Run Stock by John Lux*

Example: First American Financial (FAMR) sold as low as \$6 ½, yet in one year was selling at \$18 per share. At that time, the stock had a book value of almost \$13 per share, consisting largely of cash and government securities. Why did FAMR sell at less than half of the value of its cash and government securities? Why was it so low priced?

FAMR then suffered a substantial decline in earnings, yet the stock almost tripled. Why did FAMR go up while earnings were going down?

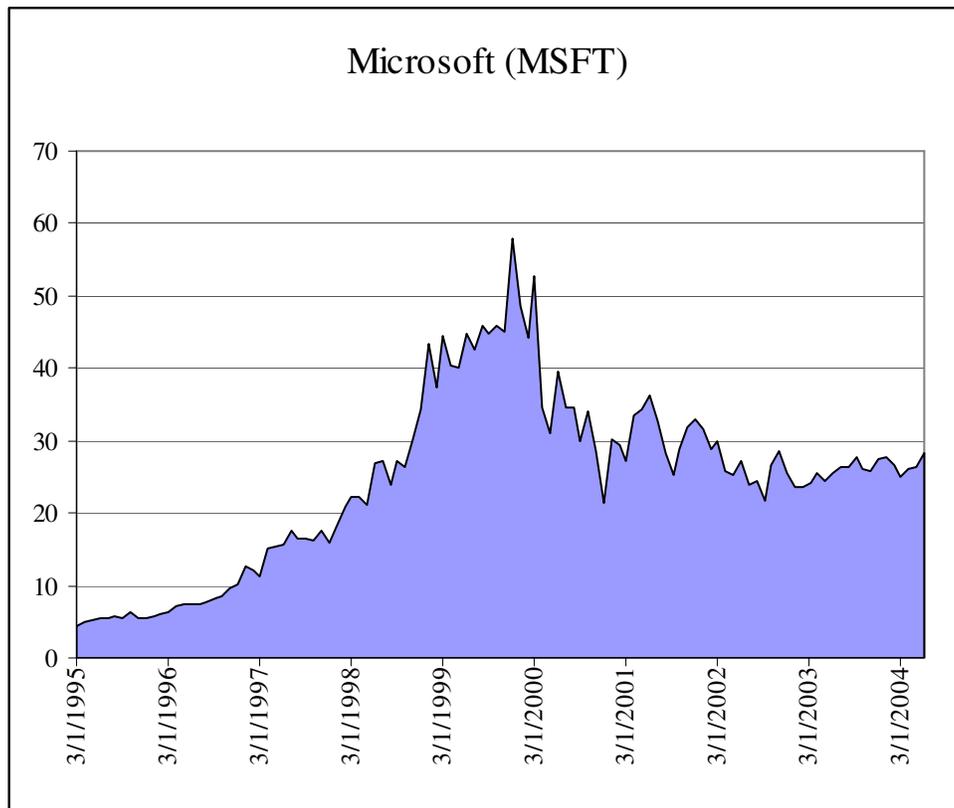
Example: In 1982, Bel Fuse was selling at \$2 per share. I knew it was undervalued, but thought it would stay that way. Two years later it reached \$15 per share and I finally bought it. Six weeks later I sold it as \$75 per share, and it went even higher in the next few months.

Example: Was Manufactured Homes fairly valued at its low of \$1 7/8 in 1984? MANH went public seven months earlier at \$3.20. From \$1 7/8 in 1984, it went to \$15 ½ in 1986. What was its real value? Keep on reading this book and find out.

What was Manufactured Homes real value? From a high of \$20 in 1987, it ran into financial difficulty and hit 25 cents in 1989!



What made Microsoft go from under \$10 in 1996 to almost \$60 two years later and then down to almost \$20 the next year? Shouldn't the stock have just gone from \$10 to \$30 and skipped almost hitting \$60? Why not?



How do we know the stock is under-priced so we can buy? How do we know when it is over-priced so we can sell?



*How to Find a Home Run Stock by John Lux*

**With all this practice thinking, you may find that you can do it easily now and answer this question for yourself:**

**What is value?**



## **What is Value?**

The definition of value is also a problem that has caused much confusion on Wall Street.

Some of this confusion has been caused by greedy people who are trying to persuade gullible investors that a security is worth more than its true value.

Of course, we all know that gold is the ultimate standard of value on earth. However, the price of gold soared from about \$100 per ounce in 1976 to over \$800 per ounce in 1980, four years later. So we see the price of gold increasing 800 percent in a four year period.

Now gold is subject to all kinds of strong emotions. So let us take another standard of value, silver. In 1979, silver sold as low as \$6 per ounce. In one year, it rose to \$50 per ounce, another 800% increase. Two years after that, it was back to \$7.

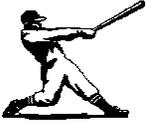


*How to Find a Home Run Stock by John Lux*

### **Price v. Value**

We call those stock market analysts who study price movements to make money in the stock market “technical analysts.” We call those stock market analysts who study the value of a company to make money in the stock market “fundamental analysts.”

However, it is not price alone, or value alone, that should be studied to make money in the stock market. What must be studied to make money in the stock market is the difference between price and value. When price and value are very different, then there is money to be made. When price and value are about equal, then there is no money to be made.



## **The One Most Important Concept**

The one most important concept is that there are two most important concepts in the stock market.

Most of the confusion and failure that I have seen in investing comes from systems based only on either price or value alone and not the difference between both price and value. Obviously, the system works. “Why does the system not work now?,” they ask.

The two most important concepts are price and value. If a stock has great value and a low price, it is a buy and will rise. If a stock has no value and a high price, the stock is a sell and will fall.

Picture a rubber band. At one end you put a label “price” and at the other a label “value”. The farther apart these two are, the more the tension in the rubber band will create motion pulling them together. Price can be way over value or price can be way under value. Either way, if there is a great difference between price and value, something is going to happen.

What is going to happen is that the price will move. Price always tends toward value in the long run. Value will rarely rise just because a stock is high priced.

We are interested in this price movement.

So we are trying to find the maximum disparity between price and value.

This leaves us with two questions that we will now examine.

One, what is value, and two, how does price move.

Confusion created by focusing on either price or value when it is the relationship between price and value that is the one important factor.

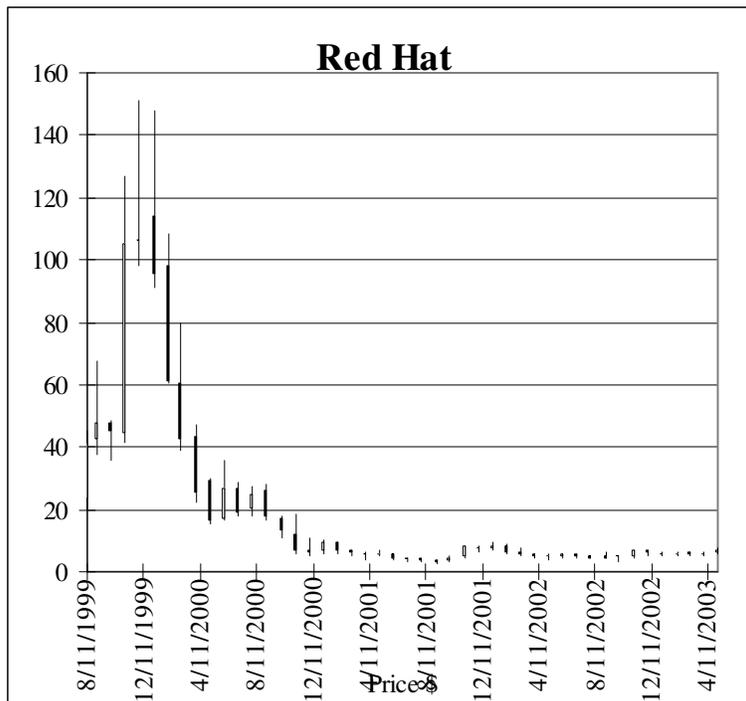


Pendulum theory: a stock trader who found many “home run stocks” created “pendulum theory.” He observed that the more a stock was undervalued, the more likely it would become overvalued. The cheaper the stock was to begin with, the more likely it would go to great heights. In other words, the more the pendulum went one way, the more likely the pendulum was to swing the other way.

Home Shopping Network (HSN) is a good example to study for the concepts of (1) disparity between price and value and (2) pendulum theory.

In 1987, HSN sold as high as \$47. At \$47, it was selling at 34 times the value of its tangible assets. I consider any stock that sells over 4 times the value of its tangible assets to be a possible sale candidate. At \$47, HSN was selling at 140 times its earnings that year. I consider any stock that sells over 30 times earnings to be a possible sale candidate. Therefore, HSN was grossly overpriced. There was a large disparity between price and value.

This disparity between price and value was corrected when the stock sank to \$5 per share before the end of the year. That was almost a 90% drop. That is pendulum theory—the stock was very overpriced and swung fast in the other direction.





*How to Find a Home Run Stock by John Lux*

Red Hat is another fine example of pendulum theory. Look at this chart and the swing in the stock price.

First, the stock jumped way up, then it swung down. Pendulum theory says that if it goes way up rapidly, it will go down rapidly.



*How to Find a Home Run Stock by John Lux*

**Time to think again:**

**What gives value to a stock?**



## **Fundamental Analysis - Value**

There are two things that give value to a company. First, the value of the assets of the company gives value to the company. Second, the earnings of the company.

My favorite analogy for the difference between the assets and the earnings is the analogy of the apple tree. A farmer owning an apple tree can cut it down and sell it for the wood. If he does so, he loses the yearly crop of apples. The wood of the tree is like the assets of a company. The assets of a company are its cash, what others owe to the company, inventory, plant and equipment, and any intangible assets like patents or lucrative business arrangements. These can be sold. However, when the company sells these assets, the company will not have any more annual earnings from those assets. The annual earnings of the company are like the apples from the tree. They are the fruit of the assets.



*How to Find a Home Run Stock by John Lux*

## **Earnings**

For our purposes, earnings may be defined as the annual earnings per share of the company.

There are many ways to fiddle with earnings to give an inaccurate number. I have listed some books that tell how this is done in the back of this book under “Further Reading.” For now, for simplicity, we are going to stick with the published numbers for earnings per share put out by the company.



## **Asset Value**

I often speak of the assets of the company, or the company's asset value. By this I mean actually the net value of the assets. The net value of the assets is the total assets of the company less the liabilities of the company. This value is also often called the "shareholders equity," or the "book value" of the company.

The relationship of earnings and assets: the assets of the company are what produce the earnings.

A clear way to see this is to look again at the fruit and the tree concept. Consider an apple tree. Every year, the farmer owning the apple tree gets the fruit and sells it. The amount he receives from selling the fruit is the earnings of the tree. The tree is an asset. It is the asset that produces the earnings.

The tree has two values. First, the tree is valuable because it produces annual earnings. Second, the tree itself has value as an asset. The farmer could sell the tree for firewood. If the tree has more value as firewood than it has producing fruit, the farmer may sell it for firewood.

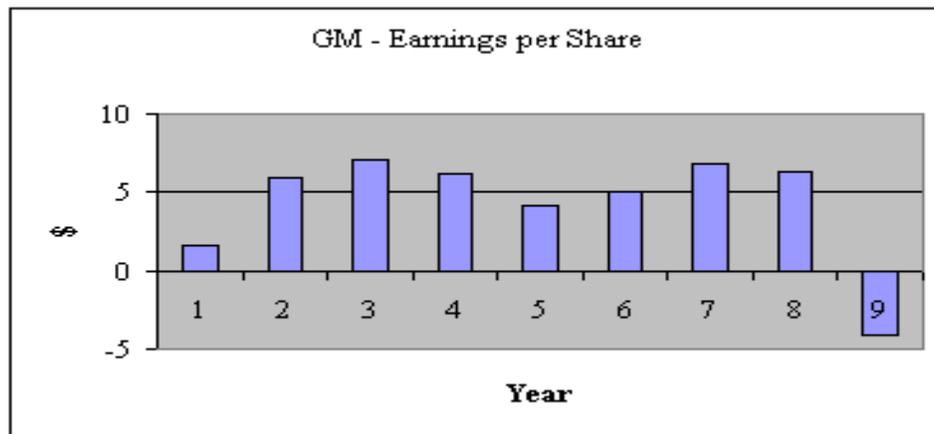
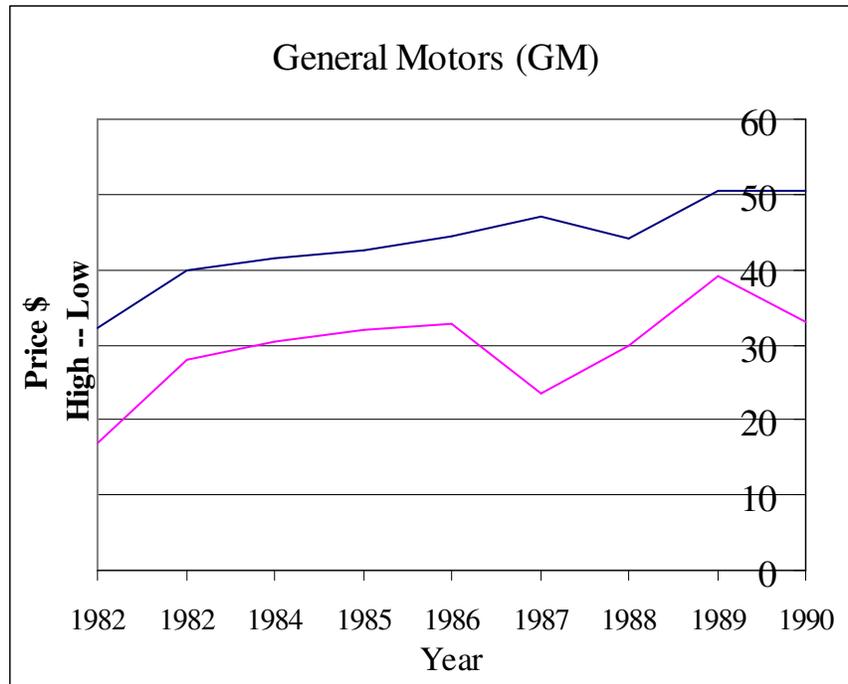
The same is true of any company. The company has assets that produce earnings. The company can either keep operating and making earnings, or the shareholders of the company can sell off the assets. They will sell off the assets if the company is "worth more dead than alive."

The question now arises, in figuring value, what is more important, earnings or assets? Most stock buyers feel that stocks sell on earnings and largely ignore assets. I disagree. Earnings can change widely from year to year. Assets are much more stable. They are much more important in figuring value.



*How to Find a Home Run Stock by John Lux*

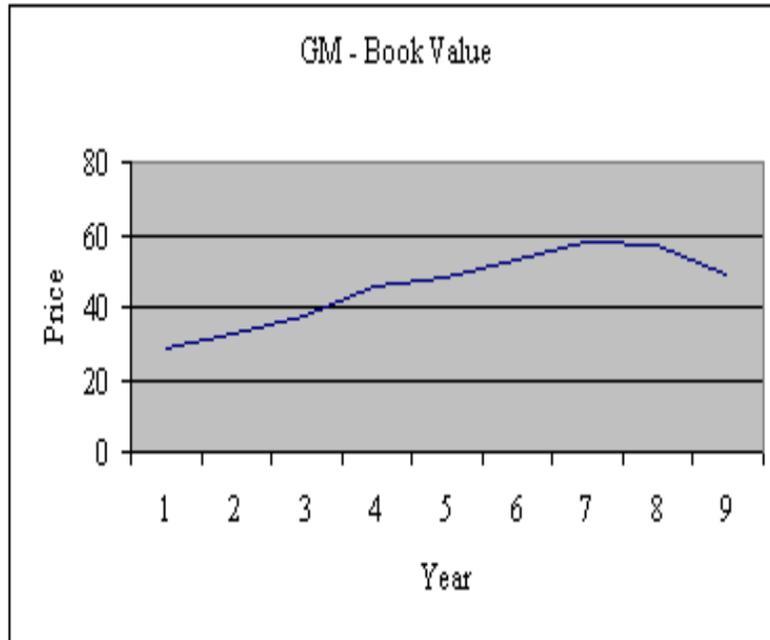
Study this chart of General Motors. Note the earnings per share and book value per share and compare them with the stock price. I encourage you to study this page carefully.



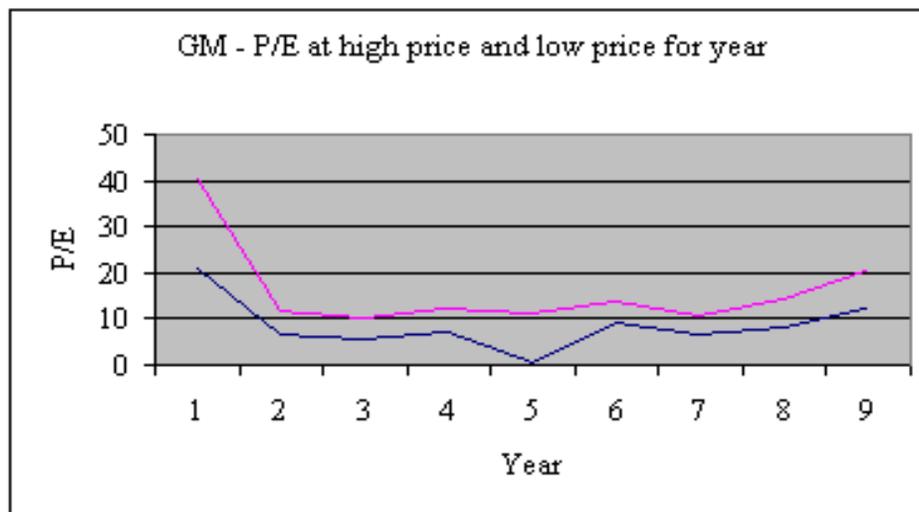
Of course, GM' stock tends to rise with GM's earnings, but not exactly.



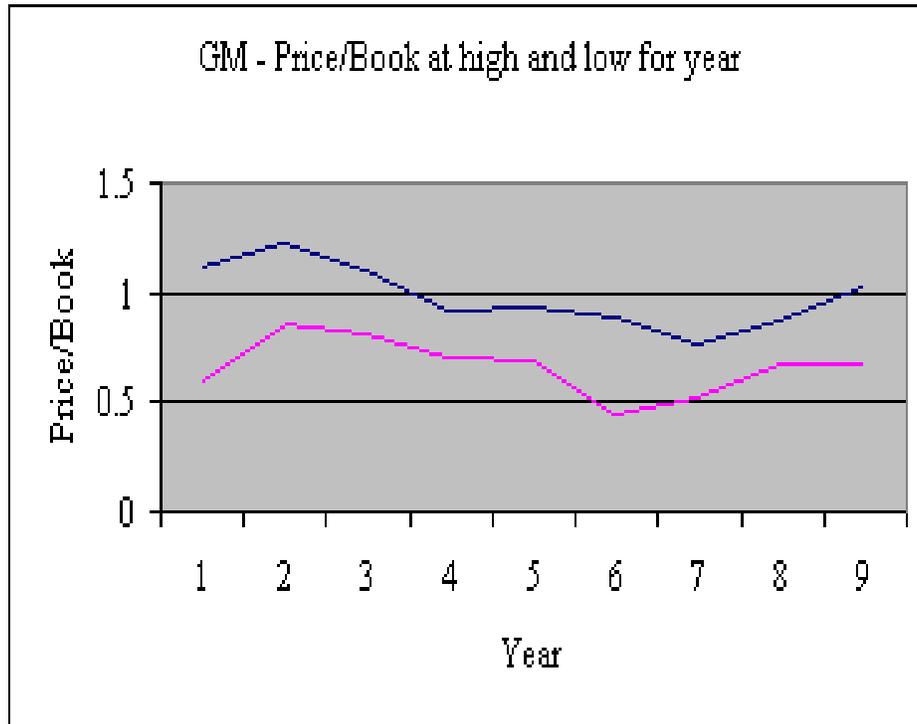
*How to Find a Home Run Stock by John Lux*



The same is true of book value.



The P/E is high in year one when the earnings are low. Normally, the P/E is in the 5-10 range.



The ratio of price to book value is more stable and shows us that the price does not go much below one-half of book value and does not go as high as 1.5 times book value.

What this tells us is:

1. We should buy if the stock price goes below one-half of book value. We should sell if the stock price is much more than book value.
2. We should be looking to buy if the P/E is around 5 and to sell if it goes into the 10-15 range.



*How to Find a Home Run Stock by John Lux*

**Now let us pause and consider in our own mind:**

**What is the value of a stock?**



*How to Find a Home Run Stock by John Lux*

When a stock is “cheap,” it is cheap in relation to its value. The stock is cheap in relation to its value, and the value is figured in terms of certain financial ratios. In order to understand and calculate these ratios, we must study the balance sheet.



## **How to Determine Value**

My method of investing depends on a rapid scan of all possible stocks. Rather than do an in depth study of a small group of large companies, say 1,300 stocks, I screen over 10,000 stocks for obvious bargains. Because we look at more stocks, we must be able to get a fast idea of the value of a stock.

Also, my method of investing says find only the best opportunities. An excellent opportunity will be very obvious. You do not need a detailed study of an excellent opportunity, since the stock should be so excellent that its excellence is readily apparent. Therefore, if the price is \$2 per share, whether the value of the company is \$10 per share or \$10.16 per share does not matter. The stock is a screaming buy whether the value is \$10 or \$10.16. Enough information on value has been gathered to make a decision. You would waste time making a further study on value, although you should make further study on other matters.

Further definition of value: It is now time to give a more detailed definition of value as I use it in research.

I define value to be the price at which I believe the stock will bottom. In other words, what is the low price for this stock? What is the price below which the stock will not go? Put another way, what is the cheapest price this stock could be bought.

I do not figure this price by a formula. I figure this price by looking at thousands of stocks. I see what price that company's stock, stocks of companies in that industry, and stock in general will bottom. In other words, I calculate this price by observation and nothing else.

In 1982, the stock market was making a major low. Many stocks sold at all time lows. So in many cases, we can look at 1982 and find out how cheap stocks of this kind usually get.



*How to Find a Home Run Stock by John Lux*

Study this chart of Mesa Air Group. Notice that when MESA gets to a certain price, it rebounds dramatically. These low points set the low for MESA. This is a cheap as the stock will get, without some drastic change in condition.



This bottom price shows the best value you can buy the stock at. This price may be figured in terms of certain financial ratios. In order to understand and calculate these ratios, we must study the balance sheet.



*How to Find a Home Run Stock by John Lux*

**How do you read the financial statements of a company?**

**What purpose do you have in mind  
when you read financial statements?**



*How to Find a Home Run Stock by John Lux*

## **Understanding the Financial Statements of a Company**

When inspecting the financial statements of a company, it is important to keep your purpose in mind. Your purpose in examining a company's financial statements is to find a good investment. A good investment is a company that has very high value and very low risk. You are trying to determine for a certainty that the company has strong assets. What is the strongest asset? Cash. You are also trying to determine if the earnings will increase.



## **The Balance Sheet**

We will now review the major balance sheet items. More detailed analysis may be learned by studying the books listed under “Further Reading” in the back of this book.

*The basic structure of the balance sheet is*

Assets = Liabilities + Equity

In other words, if you had a house worth \$2,000,000, the asset side of the balance sheet would be \$2,000,000. If the house had a mortgage of \$500,000 on it, the right side would be liabilities of \$500,000 and equity (what you own, the net worth) of \$1,500,000. Or:

Assets	\$2,000,000	Liabilities	\$500,000
		Net worth	\$1,500,000



Here is a balance sheet of Wolverine Worldwide. You may know that they make Hush Puppy shoes. On December 28, 2002, the company had total assets of \$531,994,000. This sum equals the liabilities of \$162,897,000 plus shareholders equity of \$369,097,000

### CONSOLIDATED BALANCE SHEETS

As of Fiscal Year End

	2002	2001
<i>(Thousands of Dollars)</i>		
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 27,078	\$ 35,820
Accounts receivable, less allowances (2002--\$10,191; 2001--\$7,382)	156,285	152,330
Inventories:		
Finished products	146,229	151,612
Raw materials and work-in-process	22,769	25,429
	<b>168,998</b>	177,041
Deferred income taxes	2,992	2,927
Other current assets	7,992	6,684
Total current assets	<b>363,345</b>	374,802
Property, plant and equipment:		



*How to Find a Home Run Stock by John Lux*

Land	<b>1,104</b>	1,105
Buildings and improvements	<b>62,982</b>	63,675
Machinery and equipment	<b>123,499</b>	114,018
Software	<b>38,389</b>	34,751
	<b>225,974</b>	213,549
Less accumulated depreciation	<b>128,700</b>	114,555
	<b>97,274</b>	98,994
Other assets:		
Goodwill and other non-amortizable intangibles	<b>30,706</b>	12,685
Other amortizable intangibles	<b>3,263</b>	2,272
Cash surrender value of life insurance	<b>22,628</b>	20,246
Prepaid pension costs	--	20,436
Assets held for exchange	<b>4,719</b>	5,739
Notes receivable	<b>2,466</b>	2,366
Other	<b>7,593</b>	6,138
	<b>71,375</b>	69,882
Total assets	<b>\$ 531,994</b>	\$543,678

**Liabilities and Stockholders' Equity**

Current liabilities:

Notes payable	<b>\$ --</b>	\$ 90
Accounts payable	<b>29,542</b>	28,357
Salaries, wages and other compensation	<b>12,296</b>	8,758



*How to Find a Home Run Stock by John Lux*

Income taxes	<b>3,575</b>	6,376
Taxes, other than income taxes	<b>4,322</b>	2,908
Other accrued expenses	<b>15,412</b>	13,002
Current maturities of long-term debt	<b>15,030</b>	15,030
<b>Total current liabilities</b>	<b>80,177</b>	74,521
Long-term debt, less current maturities	<b>57,885</b>	75,818
Deferred compensation	<b>4,742</b>	6,283
Accrued pension liability	<b>19,870</b>	--
Deferred income taxes	<b>80</b>	12,904
Minority interest	<b>143</b>	--
<b>Total Liabilities</b>	<b>\$162,897,000</b>	
<b>Stockholders' equity:</b>		
Common stock, \$1 par value: authorized 80,000,000 shares; issued,		
including treasury shares: 2002--45,839,831; 2001--45,413,788	<b>45,840</b>	45,414
Additional paid-in capital	<b>90,994</b>	86,771
Retained earnings	<b>339,475</b>	298,755
Accumulated other comprehensive loss	<b>(23,522)</b>	(4,109)
Unearned compensation	<b>(3,833)</b>	(4,649)
Cost of shares in treasury: 2002--5,869,429 shares; 2001--3,857,988 shares	<b>(79,857)</b>	(48,030)
<b>Total stockholders' equity</b>	<b>369,097</b>	374,152
<b>Total liabilities and stockholders' equity</b>	<b>\$ 531,994</b>	\$543,678



Now, accountants usually categorize the asset side of a conventional business into the following major categories:

1. Cash
2. Receivables
3. Inventory
4. Property, Plant and Equipment (PPE)
5. Intangibles

Accountants call cash and Inventory current assets, because cash and inventory are expected to turn over in the next 12 months, or during the current year. PPE and Intangibles will usually be in place for over 12 months. Accountants therefore call PPE and intangibles Long Term Assets.

Note that as you go down the list of these four types of assets, the characteristics of the assets change on a gradual basis. At the top of the list, we have cash, which is the most certain of easy valuation and the most liquid type of asset. At the bottom, we have intangibles. Intangibles include, for example, goodwill. The exact value of goodwill is not easy to determine, and it is certainly not liquid. So as you go down the list, the assets are more liquid and easier to value. I therefore place more value on the most liquid and the easiest to value assets and the least value on the assets that are not as liquid and the least easily valued.

On the right hand side of the balance sheet, we have liabilities, divided as are the assets into the short term and the long term variety.



The company may have purchased its own stock. Stock bought and held by the company is called “treasury stock.” Here is a balance sheet with treasury stock. Subtract the number of shares of treasury stock from the shares outstanding to find the true number of shares out. Divide the amount paid for treasury stock by the number of shares bought to find the price paid.

In the Wolverine Worldwide balance sheet that follows, the company had \$48,030,000 worth of treasury stock at the end of 2001 and \$79,857,000 worth of treasury stock at the end of 2002. So the company bought \$31,827,000 worth of treasury stock in 2002. The company had 5,869,429 shares of treasury stock in 2002 and 3,857,988 shares of treasury stock in 2001, a net increase of 2,011,441 shares. So Wolverine paid \$31.8 million for 2,011,441 shares, or \$15.82 per share.

**CONSOLIDATED BALANCE SHEETS**

As of Fiscal Year End

	2002	2001
--	------	------

*(Thousands of Dollars)*

**Assets**

Current assets:

Cash and cash equivalents	<b>\$ 27,078</b>	\$ 35,820
Accounts receivable, less allowances (2002--\$10,191; 2001--\$7,382)	<b>156,285</b>	152,330
Inventories:		
Finished products	<b>146,229</b>	151,612



*How to Find a Home Run Stock by John Lux*

Raw materials and work-in-process	<b>22,769</b>	25,429
	<b>168,998</b>	177,041
Deferred income taxes	<b>2,992</b>	2,927
Other current assets	<b>7,992</b>	6,684
Total current assets	<b>363,345</b>	374,802
Property, plant and equipment:		
Land	<b>1,104</b>	1,105
Buildings and improvements	<b>62,982</b>	63,675
Machinery and equipment	<b>123,499</b>	114,018
Software	<b>38,389</b>	34,751
	<b>225,974</b>	213,549
Less accumulated depreciation	<b>128,700</b>	114,555
	<b>97,274</b>	98,994
Other assets:		
Goodwill and other non-amortizable intangibles	<b>30,706</b>	12,685
Other amortizable intangibles	<b>3,263</b>	2,272
Cash surrender value of life insurance	<b>22,628</b>	20,246
Prepaid pension costs	--	20,436
Assets held for exchange	<b>4,719</b>	5,739
Notes receivable	<b>2,466</b>	2,366
Other	<b>7,593</b>	6,138



*How to Find a Home Run Stock by John Lux*

	<b>71,375</b>	69,882
<hr/>		
Total assets	<b>\$ 531,994</b>	\$ 543,678
<hr/>		
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities:		
Notes payable	\$ --	\$ 90
Accounts payable	<b>29,542</b>	28,357
Salaries, wages and other compensation	<b>12,296</b>	8,758
Income taxes	<b>3,575</b>	6,376
Taxes, other than income taxes	<b>4,322</b>	2,908
Other accrued expenses	<b>15,412</b>	13,002
Current maturities of long-term debt	<b>15,030</b>	15,030
<hr/>		
Total current liabilities	<b>80,177</b>	74,521
Long-term debt, less current maturities	<b>57,885</b>	75,818
Deferred compensation	<b>4,742</b>	6,283
Accrued pension liability	<b>19,870</b>	--
Deferred income taxes	<b>80</b>	12,904
Minority interest	<b>143</b>	--
Stockholders' equity:		
<b>Common stock, \$1 par value: authorized 80,000,000 shares; issued,</b>		
<b>including treasury shares: 2002--45,839,831; 2001--45,413,788</b>	<b>45,840</b>	45,414



*How to Find a Home Run Stock by John Lux*

Additional paid-in capital	<b>90,994</b>	86,771
Retained earnings	<b>339,475</b>	298,755
Accumulated other comprehensive loss	<b>(23,522)</b>	(4,109)
Unearned compensation	<b>(3,833)</b>	(4,649)
<b>Cost of shares in treasury: 2002--5,869,429 shares; 2001--3,857,988 shares</b>	<b>(79,857)</b>	<b>(48,030)</b>
Total stockholders' equity	<b>369,097</b>	374,152
Total liabilities and stockholders' equity	<b>\$ 531,994</b>	\$ 543,678



More interesting is the shareholders equity part of the balance sheet.

The liabilities and shareholders equity part of the balance sheet may have its own gradual change in the character of the items. The company is supposed to pay short term debt first. Generally, short term debt has little or no interest. The long term debt participates in the pre-tax profits of the business but only to the extent of the interest to be paid pm the debt. Next we have preferred stock, which takes its share of the profits before the common stock. However, preferred stock, unless otherwise agreed, also has a limited participation in the profits of the business. Next we have the common stock, which takes up the balance of the profits left over after the senior securities, the debt and preferred stock. There is no limit on the participation of the common stock in the profits of the business. Common stock has the most appreciation potential.

Now let me give you an example of how an investor thinks creatively with these concepts. These concepts are tools to be used. They sound very simple, but they have great power for an investor who will think about how to use them.

I was studying the balance sheet one day. I noted that the best asset to have was cash. I also noted that the best security was one as far down on the right hand side as possible. I realized that there is the possibility of buying a security that has leverage that might even be better to own than the common stock.

For example, a person could buy a warrant on the common stock. A warrant is simply the right to buy common stock at a given price for a given time. You could have a warrant that is the right to buy a stock at \$5 per share for one year. If the stock was selling at \$5, the warrant probably would sell for \$ ½. It would be cheaper to buy the warrant. The warrant would tie up only 10% of the money that you would have to pay to buy the common. Both would participate in a rise in value of the company. A one point increase in the value of the common stock would bring you a 20% profit. However, a one point rise in the value of the common stock should increase the value of the warrant by about one point, giving you a 200% profit. Conversely, if the



*How to Find a Home Run Stock by John Lux*

stock went down a point, the warrant might be worthless, so a 20% drop in the stock price would give you a 100% loss in the warrant.

So I concluded that the best type of investment would be a warrant on stock in a company that has a lot of cash. I found such a company shortly thereafter. The stock was selling at about the value of the cash in the company. The warrant was low priced. We bought the warrants and they fortunately doubled in one week, whereupon we took our profit.

Investors in bankrupt companies also look at these concepts implicitly. They will study which securities will survive the reorganization. The common may be worthless, for example, but there may be enough value there to give value to the preferred.



## **The Earnings Statement**

If the shareholders equity is the tree, then the annual earnings are the fruit of the tree.

At the top of the statement is the figure for gross revenues or sales (1). This number is important because the larger the sales, the more that can be taken out of them for profits.

After the cost of goods sold (2), we find the number for gross profit (3).

After selling, general and administrative expense (4), we find the number for earnings before interest and taxes (5). This is a measure of the borrowing power of the company.

After interest and taxes, we come to the net income figure (6). This is the number that represents the fruit of the tree.

1	Sales	\$100,000
2	Cost of good sold	60,000
3	Gross profit	40,000
	Selling, general \$	
4	administrative expense	30,000
	(SG&A)	
5	Earnings before interest	10,000
	and taxes (EBIT)	
	Taxes	3,000
6	Net income	7,000
	Shares outstanding	100,000
	Earnings per share	
	(EPS)	\$0.07



## **Leverage**

The dictionary defines "leverage" an increased means of accomplishing a purpose. Leverage allows the investor to increase his profits for a given increase in value. We have already discussed how the use of a warrant may increase profit over the profit from a conventional investment in common stock.

There are several types of leverage. First, there is the leverage an investor might gain by buying a security on margin. Second, an investor might buy an option or a warrant. Third, there is the internal leverage a company has from favorable company financial characteristics.

If an investor buys a security on margin, he needs only deposit 50% of the purchase price. He may therefore buy twice as much stock with the same amount of money. He will have twice the profits if the stock goes up and twice the losses if the stock goes down.

I have already illustrated the use of warrants. Some stocks have options. However, in my experience, listed options expire in such a short period of time that they are hardly worth buying. The premium paid in buying options is so large that the investor rarely profits.

The company also may have favorable internal financial characteristics that provide leverage.

First, the company itself may have taken on considerable debt. This allows the company to expand its chances to profit. However, it must pay the debt.

Further, the company may have a small profit margin that is increasing. Suppose company A makes 10% on sales after tax and company B makes 1% on sales after tax. Then if both companies increase sales margins by 1%, company A will have a 10% increase in profit, and company B will have a 100% increase in profit. Company B's stock will rise much faster than company A's stock. We call this operating leverage.



In addition, the company may have considerable sales in relation to its market value. Companies take profits from dollars that come in as sales. The larger the sales, the more opportunities to find profits. Therefore, I would rather buy the company that has the most sales or revenues compared with the market value of the company's stock. We calculate a ratio by dividing revenues by the market value of the stock. We calculate the market value of the stock by multiplying the number of shares outstanding by the price of a share. I call this ratio the Revenue to Market Value ratio or RMV for short. RMVs vary from industry to industry. As a rule of thumb, rarely buy stock with an RMV lower than 1, and generally look at stocks for possible buys if they have RMVs of 3 or 4.

There is another form of leverage that is often overlooked.

This is the leverage that occurs when the price/earnings multiple expands (or contracts). As a stock is discovered and the value of the company is realized the P/E ratio will expand.

For example, if the earnings have been flat, the stock might trade at a P/E of 6. That is if it earns \$1 per share, it will sell at \$6 in the market. However, if the earnings grow rapidly, then the stock will be now perceived as a growth stock that deserves a higher P/E multiple. So if the stock now makes \$2 per share in earnings, it will not just sell at the same P/E of 6 or \$12 per share. The stock may now be seen as a growth company and get a P/E of 20, and sell at \$40 per share. This is quite a pleasurable phenomenon if you are long. While the earnings go from \$1 to \$2 per share, the stock price goes from \$6 to \$40.

Now for the biggest reason I refuse to pay a high price/earnings ratio for a stock—P/E contraction. Suppose the stock sells at a growth P/E of 30, at a price of \$60 per share because it makes \$2 per share in earnings. Now the company announces that earnings will decline to \$1 per share and stay there. The stock now deserves a non-growth P/E multiple of 10. It makes \$1 per share, so it sells at \$10, down from \$60. The stock declines 80% even though the earnings are only cut in half.

Here is my all time favorite example of the results of an earnings surprise and the resulting P/E and price deflation. In 1983, Texas Instruments (TXN) was a favorite in the semiconductor industry. *The Wall Street Journal*, on



*How to Find a Home Run Stock by John Lux*

January 18, 1983, reported that brokers were recommending semiconductor issues and TXN went up almost 10% in two days to a price of 151.

Five months after being endorsed by the brokerage community and being in *The Wall Street Journal*, TXN announced its earnings surprise. As *The Wall Street Journal* reported, “Computer Maker Sees \$100 Million 2<sup>nd</sup>-Period Loss.” Just two months earlier, TXN’s president told shareholders at the annual meeting that 1983 hold the promise of being a significantly better year than 1982. A sharp sales decline and price-cutting ended these hopes.

TXN opened down over 38 points, a 25% loss. Fully 72% of the stock was owned by institutions. Generally, the institutions wanted out of a stock known publicly to be a big disaster, so that their portfolios would not embarrass them on June 30, the closing of the quarter.

The next day the stock went to \$107, on volume of over 1.2 million shares. Here we have a stock losing 1/3 of its value in two days because of the deflation of its P/E due to an earnings surprise.



## **Ratios**

I will generally calculate at least five ratios for interesting companies, and use these ratios to determine which companies merit further study.

In calculating ratios, the number I use for common shares outstanding is the total number of shares out less the number of shares owned by the company itself (treasury stock).

I calculate the following ratios for all companies of interest:

**Cash per share.** Take the cash and near cash investments of the company and divide by number of common shares outstanding. Companies generally do not well below the cash per share.

**Working capital per share.** First, take the current assets and subtract the current liabilities. This gives working capital. Then divide by the number of shares. Companies generally do not sell much below working capital per share. I try to stick mostly to buying companies that have current ratios (current assets/current liabilities) of at least 2 to 1.

**Book value per share.** Shareholders equity divided by number of shares. Deduct intangibles, like goodwill.

**P/E ratio.** The earnings per share divided by number of shares.

**Market value to revenue ratio.** Find the market value by multiplying market price by number of shares outstanding. Divide sales by the market value. The more the RMV, the greater the chance that the earnings can go up.

**Price the company buys its own stock at.** If the company has purchased its own stock in the last year, this will show up in the section on shareholders equity under treasury stock. Divide the total amount paid by the number of shares to find the price. This is an excellent indicator of value as determined by the people that run the company.



One point you must know about the shareholders equity portion of the balance sheet. The company may have convertible bonds, convertible preferred, warrants or options. Conversion into common of these securities would increase the number of shares outstanding and drastically affect the validity of your calculations.

Wolverine Worldwide has \$27,078,000 of cash (and cash equivalents). The company has 45,839,831 shares outstanding. Subtract the 5,869,429 shares of treasury stock, and get 39,970,402 shares out. Therefore, the company has about \$ 0.68 of cash per share

---

## CONSOLIDATED BALANCE SHEETS

	As of Fiscal Year End	
	2002	2001
<hr/>		
<i>(Thousands of Dollars)</i>		
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 27,078	\$ 35,820
Accounts receivable, less allowances (2002--\$10,191; 2001--\$7,382)	156,285	152,330
Inventories:		
Finished products	146,229	151,612
Raw materials and work-in-process	22,769	25,429
	<hr/>	
	168,998	177,041
Deferred income taxes	2,992	2,927
Other current assets	7,992	6,684



*How to Find a Home Run Stock by John Lux*

---

Total current assets	<b>363,345</b>	374,802
Property, plant and equipment:		
Land	<b>1,104</b>	1,105
Buildings and improvements	<b>62,982</b>	63,675
Machinery and equipment	<b>123,499</b>	114,018
Software	<b>38,389</b>	34,751
	<b>225,974</b>	213,549
Less accumulated depreciation	<b>128,700</b>	114,555
	<b>97,274</b>	98,994
Other assets:		
Goodwill and other non-amortizable intangibles	<b>30,706</b>	12,685
Other amortizable intangibles	<b>3,263</b>	2,272
Cash surrender value of life insurance	<b>22,628</b>	20,246
Prepaid pension costs	--	20,436
Assets held for exchange	<b>4,719</b>	5,739
Notes receivable	<b>2,466</b>	2,366
Other	<b>7,593</b>	6,138
	<b>71,375</b>	69,882
Total assets	<b>\$ 531,994</b>	\$ 543,678

---

**Liabilities and Stockholders' Equity**

Current liabilities:



*How to Find a Home Run Stock by John Lux*

Notes payable	\$	--	\$	90
Accounts payable		<b>29,542</b>		28,357
Salaries, wages and other compensation		<b>12,296</b>		8,758
Income taxes		<b>3,575</b>		6,376
Taxes, other than income taxes		<b>4,322</b>		2,908
Other accrued expenses		<b>15,412</b>		13,002
Current maturities of long-term debt		<b>15,030</b>		15,030
<hr/>				
Total current liabilities		<b>80,177</b>		74,521
Long-term debt, less current maturities		<b>57,885</b>		75,818
Deferred compensation		<b>4,742</b>		6,283
Accrued pension liability		<b>19,870</b>		--
Deferred income taxes		<b>80</b>		12,904
Minority interest		<b>143</b>		--
Stockholders' equity:				
Common stock, \$1 par value: authorized 80,000,000 shares; issued,				
including treasury shares: 2002-- <b>45,839,831</b> ; 2001-- 45,413,788		<b>45,840</b>		45,414
Additional paid-in capital		<b>90,994</b>		86,771
Retained earnings		<b>339,475</b>		298,755
Accumulated other comprehensive loss		<b>(23,522)</b>		(4,109)
Unearned compensation		<b>(3,833)</b>		(4,649)
Cost of shares in treasury: 2002-- <b>5,869,429</b> shares; 2001-- 3,857,988 shares		<b>(79,857)</b>		(48,030)
<hr/>				



*How to Find a Home Run Stock by John Lux*

Total stockholders' equity	<b>369,097</b>	374,152
<hr/>		
Total liabilities and stockholders' equity	<b>\$ 531,994</b>	\$ 543,678
<hr/>		



*How to Find a Home Run Stock by John Lux*

Try calculating the ratios based on this data:

<b>Item</b>	<b>\$</b>
Sales	50,000,000
Net profit	2,000,000
Cash	6,000,000
Current assets	12,000,000
Current liabilities	5,000,000
Stockholders equity	10,000,000
Shares outstanding	2,000,000
Price	

Calculate these ratios:

*RMV*

*P/E*

Cash/share

Working capital/ share

Book value



*How to Find a Home Run Stock by John Lux*

Here are our calculations:

<b>Item</b>	
Sales	50,000,000
Net profit	2,000,000
Cash	6,000,000
Current assets	12,000,000
Current liabilities	5,000,000
Stockholders equity	10,000,000
Shares outstanding	2,000,000
Price	4.00
RMV	6.25
P/E	4
Working capital per share	3
Book value	5



*How to Find a Home Run Stock by John Lux*

Here are some important rules for applying the guidelines for ratios.

These guidelines do not work well for banks, savings and loans, other financial companies, utilities and some other industries.

The ratios themselves are only rules of thumb. Do not use them in a rigid, mechanical way.

Generally, listed stocks have better ratios than unlisted.

NASDAQ stocks have better ratios than pink sheet stocks.

Marginable stocks will have better ratios than non-marginable. Large cap (cap = capitalization = price times number of shares out) have better ratios than smaller stocks. This means that the serious bargain hunter will look for non-marginable stocks in the pink sheets or bulletin board if that stock is likely to upgrade its listing status in the future..



## **Range of ratios**

Cash per share: It is unusual to find a company selling for less than the cash per share. Companies priced less than the cash per share are almost always terrific buys. No cash indicates a company that is in poor shape.

Working capital per share. Companies selling below their working capital per share are usually of interest.

Book value. I like to buy stocks that are selling for one-half of book value or less. I generally do not consider going short a stock unless it is selling for four times book value. Technology stocks, if they are healthy, rarely go below book value.

P/E. A P/E of four generally shows that the stock bears investigation as a possible buy. I rarely pay over 6 P/E for a stock, never over 10. I do not generally short a stock with a P/E less than 30. Technology stocks, if they are healthy, usually do not go below a 10 P/E.

Market value to revenue ratio. I like to see companies with RMVs of 3 or 4, i.e., the market value is  $\frac{1}{3}$  or  $\frac{1}{4}$  of the revenues. I would consider going short stocks were the market value is 3 or 4 times sales.



### **Which Ratio to Use in Selecting a Stock**

The answer to the question about which ratio is most important in stock selection is easy. They all are. Choose only those stocks that are selling near cash per share, below working capital, at one-half of book value, with P/Es of 4 or less, RMVs of 4 and you will sleep at night. Choose only those stocks that offer you every advantage. Why settle for less? Make sure all the ratios are in favorable territory. You can make exceptions if you have two or three ratios in range, but only for good cause shown. We call a stock that meets this formula, a “formula stock.”

If you have not found such a gem, keep looking. Do not compromise. There are 40,000 stocks out there. Have you looked at them all yet?



Now, this is a table that bears reading and evaluation.

In 1984, when the stock is below book value, at a P/E of 3, and with an RMV of 5, it is at a low price. In 1987, at over 6 times book value, with a P/E of 31, and an RMV of 2 it reaches its high of 20.

**Manufactured Homes, Inc.**

<b>Year</b>	<b>1983</b>	<b>1984</b>	<b>1985</b>	<b>1986</b>	<b>1987</b>	<b>1988</b>	<b>1989</b>
High price	2.75	4.5	15.5	16.5	20	15.75	7.37
Low price	1.88	1.88	4.5	8.87	8.87	5.25	0.25
Cash per share	0.39	0.38	0.8	3.41	4.15	3.15	0.46
Working capital per share	0.94	1.29	1.31	3.71	7.37	4.98	(10.0)
Book value per share	1.42	2.19	2.89	3.23	3.38	0.34	(9.41)
RMV at high	1.06	2.14	1.36	1.76	2.32	1.76	1.76
RMV at low	1.56	5.13	4.69	3.27	5.22	3.27	3.27
P/E at high	13	6	16	31	100	-	-
P/E at low	8	3	5	17	44	-	-



## **Making the Search**

### **Get It and Throw It Away**

The first rule in reviewing stocks is to speed the search by finding some fast excuse to discard the stock. Most people feel that they have to give each stock careful study. No! You are not trying to include the stock in; you are trying to throw it out. There are 40,000 public companies in the U.S. market. Order 10,000 annual reports (as I have) and place them in your living room. You will soon feel as I do. The best thing is to find a fast reason to throw out that annual report in your hand and as many others as possible. You need a wide search to find the best stocks, but you need to narrow the search as fast as possible to be efficient.

What you are trying to do is (1) get all the stocks that are cheap (2) then go on and use more careful study to find the cheap ones that are likely to go up. From this group, you will select the best.

So I might search the list of 40,000 stocks to find 10,000 stocks that I should read an annual report or a tear sheet on. From these 10,000 stocks I will find the 100 that are the cheapest. That 100 will be 1% of the 10,000 stocks searched. This gives you an idea of how picky you can be. From this 100, you will select only 5 or ten to buy (or sell short). So you will be selecting the top 1/10<sup>th</sup> of 1% or the top 1/20<sup>th</sup> of 1% of all stocks looked at.

It can be difficult to find the stocks that go up. For example, one of the stocks I found in 1984 was a company called Lipe Rollway. This stock had one of the highest RMVs of any stock I surveyed that year. Look at the numbers in the table. The stock has \$51 million in sales, 750,000 shares outstanding, selling at \$6, giving it a market value of \$4.5 million and an RMV of over 10. LIPE had \$11.8 million in working capital (net current assets), or about \$15 per share. But as long as I traded it, it never moved.

An undervalued stock can stay undervalued—forever.



*How to Find a Home Run Stock by John Lux*

**Lipe-Rollway Corp.**

<b>Year</b>	<b>High Price</b>	<b>Low Price</b>
1980	8.25	4
1981	8.25	5.5
1982	8.25	6.25
1983	7	6
1984	8	6.25



*How to Find a Home Run Stock by John Lux*

You can find any number of investment research services on the Internet. One link is Yahoo's Investment Services. Search engines also offer such links: Lycos, Altavista,

Direct links include Multex.com,

Sites offering company profiles.

Sites allowing you to search by financial ratios.

You can get fast and detailed company information by going to the SEC database, <http://www.sec.gov/edgar.shtml>. Other sites take this information and add to its usability. These include [www.10kwizard.com](http://www.10kwizard.com), and [www.freeedgar.com](http://www.freeedgar.com). I highly recommend these to the serious investor.

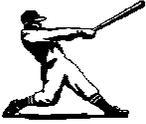
In print, you can go to your local library and they will usually have Standard and Poors Corporate Records, Value Line, and Mergents.

The stocks that are not listed on the New York Stock Exchange, American Stock Exchange, or the NASDAQ market trade on the OTC Bulletin Board. You can find information on these companies at [www.otcbb.com](http://www.otcbb.com).

The “Pink Sheets” –are now on the Internet – [www.pinksheets.com](http://www.pinksheets.com).

The National Stock Summary. Like the pink sheets, this is also published by the National Quotation Bureau. This is the most complete listing of stocks. It includes every stock quoted in the U.S. for the last few years. This is for the truly professional stock picker.

You will first review all the stocks you can using these resources. In the smaller stocks that do not report to the SEC, the only way is to ask for company information from the company itself. My standard request letter reads:



*How to Find a Home Run Stock by John Lux*

*Please send me the following information on your company:*

*10-K, 10-Q, 8-K and proxy*

*Annual report, quarterly reports, and new releases.*



*How to Find a Home Run Stock by John Lux*

Websites allowing you to search by financial ratios:

(Please notify me at [omittedlinks@asklux.com](mailto:omittedlinks@asklux.com) if you would like to be included in this list or if you know of any sites that have been omitted.)

[Multex.com](http://Multex.com)

[Yahoo.com](http://Yahoo.com)

Quicken Brokerage Stock Search

[www.stockworm.com](http://www.stockworm.com)

<http://s1.simplystocks.com/>

<http://www.stockfetcher.com/>

[www.wallstreetmentors.net](http://www.wallstreetmentors.net)

Hoover's Online: StockScreener

Websites offering company profiles:

(Please notify me at [omittedlinks@asklux.com](mailto:omittedlinks@asklux.com) if you would like to be included in this list or if you know of any sites that have been omitted.)

Hoover's Online - Home Page

Wright's Company Profiles

Yahoo! Finance Company and Fund Index

[www.Corporateinformation.com](http://www.Corporateinformation.com)



*How to Find a Home Run Stock by John Lux*

The 10-K is the annual report to the SEC. The 10-Q is the quarterly report to the SEC. They will contain information not given in the annual report and quarterly reports.

Some companies do not always send you the information requested. Some may not answer at all. Some may be out of the report requested. Some may send part of the information and not all.

State corporate law puts certain requirements on any company to provide information to shareholders, but not outsiders. These laws vary from state to state.

Since the company may not answer if the insiders are trying to dampen investor interest and keep the price down, it is a good idea to chase these issues. Of course, the company may not answer if it is broke and can't afford to send the material.



*How to Find a Home Run Stock by John Lux*

Next, the postman will dump bags of mail on your doorstep or you will have tons of companies to look at from your Internet searches.

If you have paper information, take the annual reports out of the envelope and mark current quotes on them. If you have been ordering from the National Stock Summary, you will need the pink sheets for all the quotes. [www.pinksheets.com](http://www.pinksheets.com).

Now you can go through the annual reports and try to get rid of them. Just take the price and the financial statements and try to eyeball the ratios. If the ratios are not very good, for longs, or very bad, for shorts, just throw the company out.

If the ratio is very good or very bad, then calculate all the ratios and read the company's material.

You will now have piles of reports. Take those that you have any doubt about and throw them out, too. Take those that you are excited about finding and do a check for insider trading on Vickers.

Vickers is a computer database that gives all of the institutional and insider trading data. Vickers records the 13Ds (reports by those buying or selling over 5% of the stock), Form 4s (trading by officers and directors), and Form 144s (sales by those with unregistered stock).

Websites allowing you to research insider trading include:

MSN Money - Insider Trading Stock Transactions

Quicken Brokerage - Insider Trading

PCQuote.com - Insider Trading

Lycos Finance - Insider Trading

Vickers Stock Research

Thomson - Insider Trading Center

Yahoo also gives insider trading. Insiders must also file with the SEC and such reports are found in the SEC EDGAR database.



## **Interpreting Insider Trading**

I hesitate to buy or short a stock unless the insiders are in there with me buying and selling.

Insiders may have other reasons to sell than a bad outlook for the company. But they rarely sell for these reasons if the stock is dirt cheap. They may also not buy even though the stock is cheap and the outlook is good. I recall buying heavily into a stock I made a market in and offering part of the stock to the insiders, who refused to buy. The stock then tripled.

But who else knows the company better?

I have more confidence in buying if the insiders are putting their money alongside mine. Only in one stock have I traded where heavy insider buying was followed by a loss.



*How to Find a Home Run Stock by John Lux*

**What makes a stock grow rapidly for years on end?**



## **Proprietary Position**

One of the things to look for in a company is to see if it has what has been called a proprietary position or franchise. In other words, look to see if the company has a mini-monopoly on its line of business.

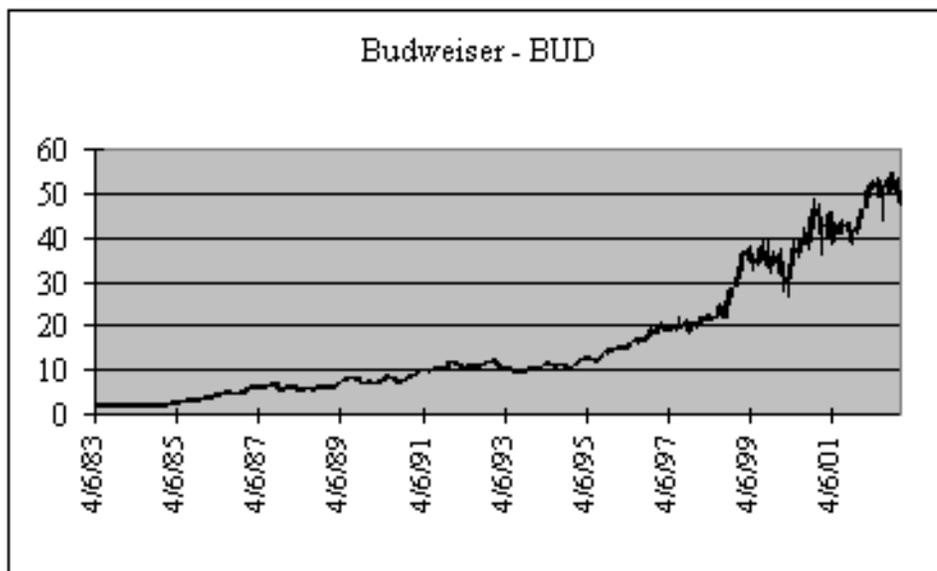
This mini-monopoly may stem from any condition. Sometimes it may stem from a brand name, a method of producing the product, a business concept, or a lock on marketing. There is no limit to the factors that could give one company a competitive advantage.

Just remember that all competitive advantages come to an end some day.

Also, a proprietary position is not enough. The company must have an expanding market to use this position in.

Here are some famous examples of what a proprietary position can do for a company and a stock:

Anheuser-Busch. Note the continued progress of the stock.

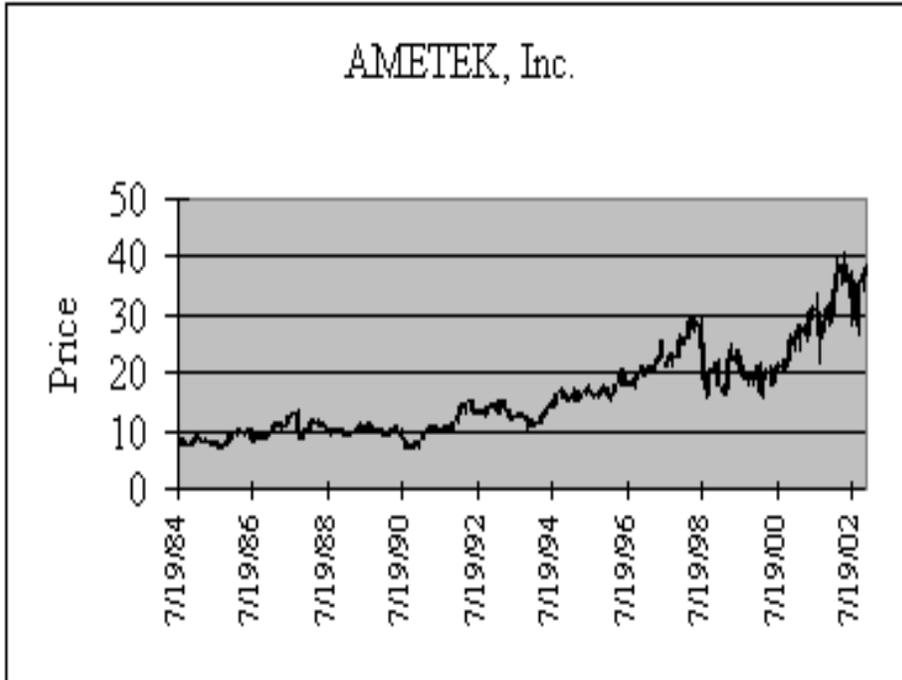


This franchise is kept alive by continuous advertising.



*How to Find a Home Run Stock by John Lux*

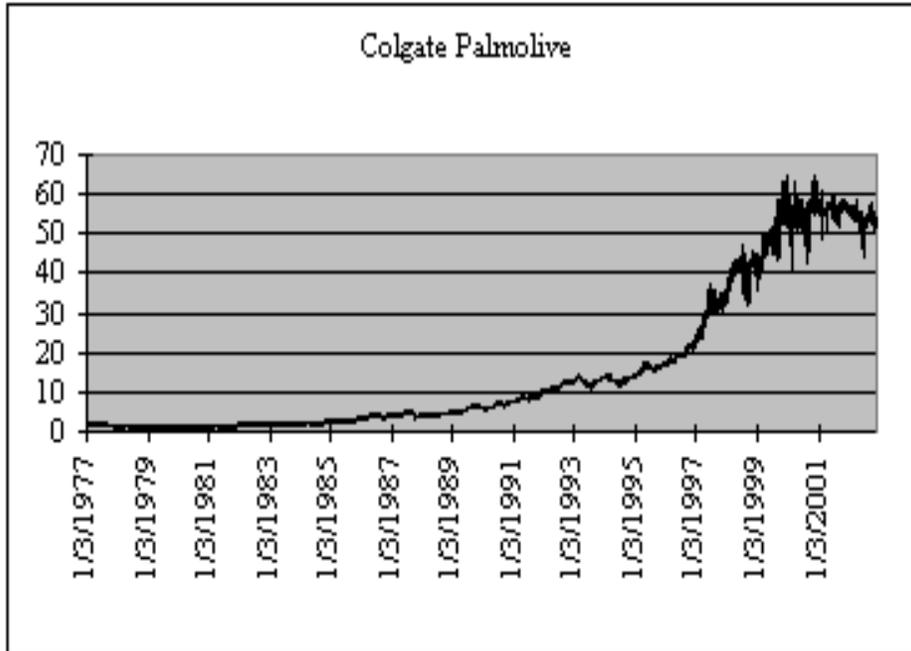
AMETEK became a niche stock by finding many small niche markets instead of one big one.





*How to Find a Home Run Stock by John Lux*

Colgate Palmolive has grown on the strength of its brands.

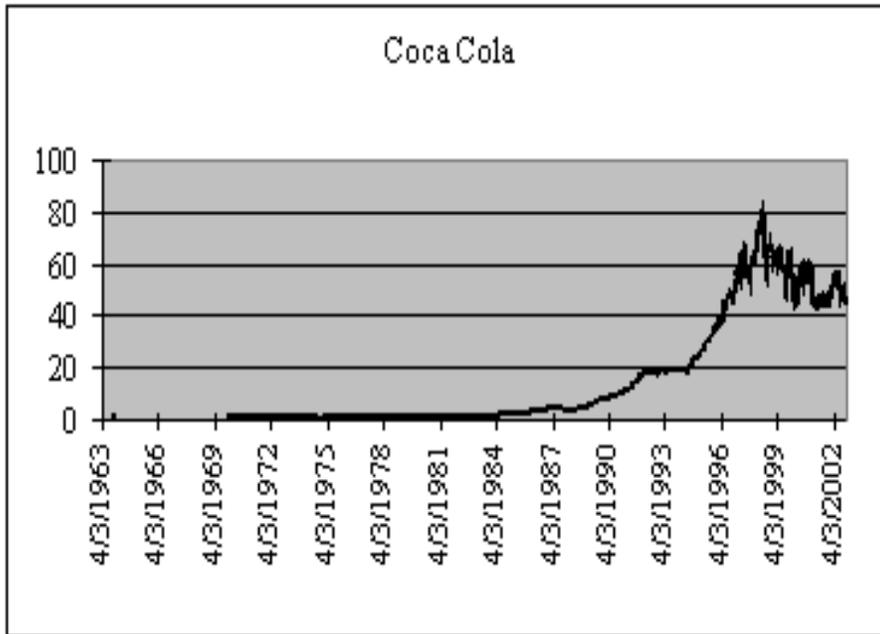


Companies that depend on patents can maintain their edge by doing more research to get new technology. However, if this gets into a large expenditure on R&D all the time necessitated by the same activity by the competition, then the company is in what I call an “R&D arms race” and should be avoided. One slip in this race, one wrong turn in the research, and the company sinks.



*How to Find a Home Run Stock by John Lux*

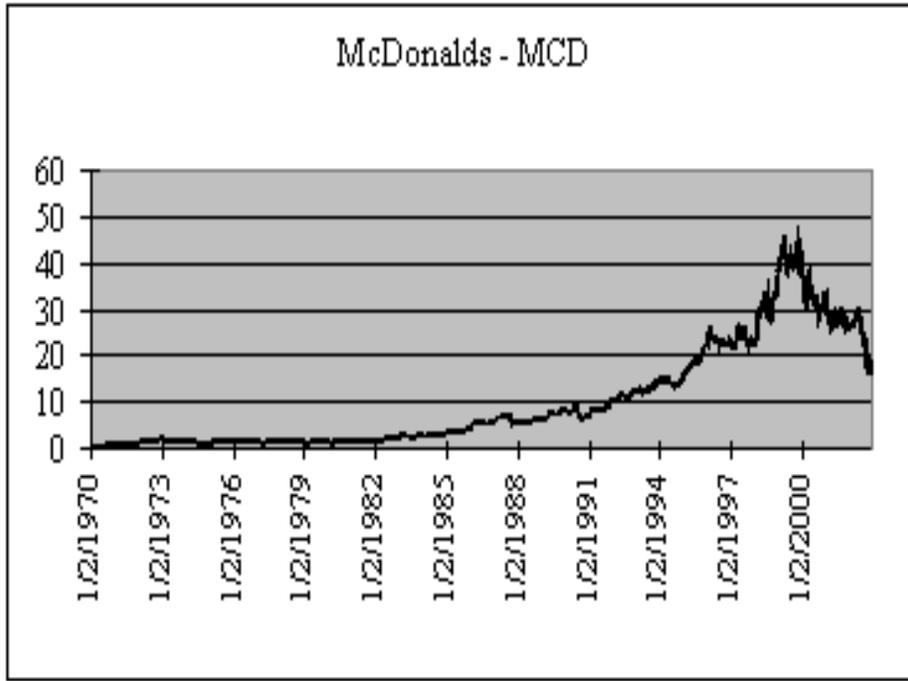
Coca-Cola has one of the best brand names.





*How to Find a Home Run Stock by John Lux*

McDonald's is, of course, a stock with a strong franchise.





*How to Find a Home Run Stock by John Lux*

**How high a P/E is OK to buy?**



*How to Find a Home Run Stock by John Lux*

Now that you have seen some phenomenal stocks, let me show you why I do not favor just buying these stocks and waiting.

The chart on the next page is a chart of P/E ratios. We assume that the stock has different P/Es now, from a P/E of 10 to a P/E of 40.

We also assume that in five years, something may have gone wrong in the market, and the stock might sell at a P/E of 10.



## **The Fallacy of Growth**

P/E now	10	15	20	30	35	40
P/E five years from now	10	10	10	10	10	10
Percent growth in EPS needed to double	19	32	42	57	63	68

In the case that the P/E falls in five years to a P/E of 10, this table tells us what amount of earnings growth could put the stock at a price at which it would be a mere double in five years.

A 100% gain divided by 5 years is only 20% per year on a simple computation.

On a compounded basis—with the returns reinvested each year—you need make only 15% per year to double your money in five years. At an original P/E of 30, you need a growth in earnings of 57% per year.

This type of growth is rare, if not non-existent, on a five-year period.

Growth is a great risk, in my opinion. Better to bet on what exists now -- assets and near-term earnings in a cheap stock.

\



*How to Find a Home Run Stock by John Lux*

How steep is that 57%? Well, let's look at the growth rate of the big growth stocks mentioned earlier. We'll take the years of 1982 to 1987, generally recognized as boom years. In 1982, the economy was depressed and started a strong comeback. No clouds were on the horizon until late 1987.

<b>Stock</b>	<b>EPS 1982</b>	<b>EPS 1987</b>	<b>Simple % change</b>	<b>Compound % change</b>
Anheuser-Busch	0.95	2.04	23	21
Bandag	1.54	3.9	31	26
Coca-Cola	0.66	1.21	17	16
McDonalds	0.74	1.45	19	18

In other words, out of these great growth stocks, the best percentage growth in earnings in five good years was 31%, far short of the 57% needed to insure a margin of safety just to get at crummy 15% return per year. As I write this, Microsoft's earnings growth rate is 27.6%.

In other words, paying a high P/E to get growth is foolish. The growth rarely catches up with the price you paid, or at least you have given yourself a substantial handicap.

Surprise! Find another expert who has realized the effect of P/E on the return on investment in growth stocks.



*How to Find a Home Run Stock by John Lux*

**Which is more important to an investor, assets or earnings?**



### **Asset Value v. Earnings**

There once was a debate in my mind as to what was more important in picking home run stocks, assets or earnings, the tree or the apples?

In my opinion, the assets are more important. For this reason, earnings are in the future and subject to wide fluctuations from a variety of factors, most of which are out of the immediate control of management.

However, a stock selling for one-half of the cash in the company per share is not likely to lose a large amount of that cash in the relatively short time frames during which I invest -- 6 months to one year. The stock is undervalued now. To bring it to full value would at least double the price. That much is sure.

Buying cheap reduces risk.



*How to Find a Home Run Stock by John Lux*

**How do you know when a stock is going up or down?**



## Technical Analysis - Price

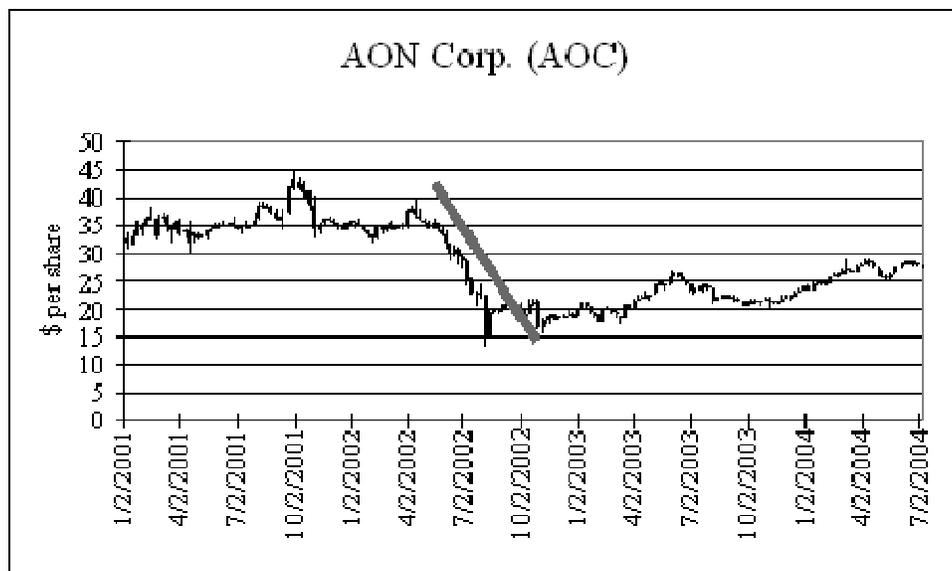
We call the study of stock prices technical analysis.

Technical analysts try to find price trends, changes in the volume of trading, and they may use moving averages or some other more sophisticated mathematical tool.

## Price

I will now introduce you to several advanced laws of price movement. These laws sound fundamental, but they cannot be fundamental since only advanced stock traders use them.

1. A price going down is a price going down. Price going down looks like this on the chart:





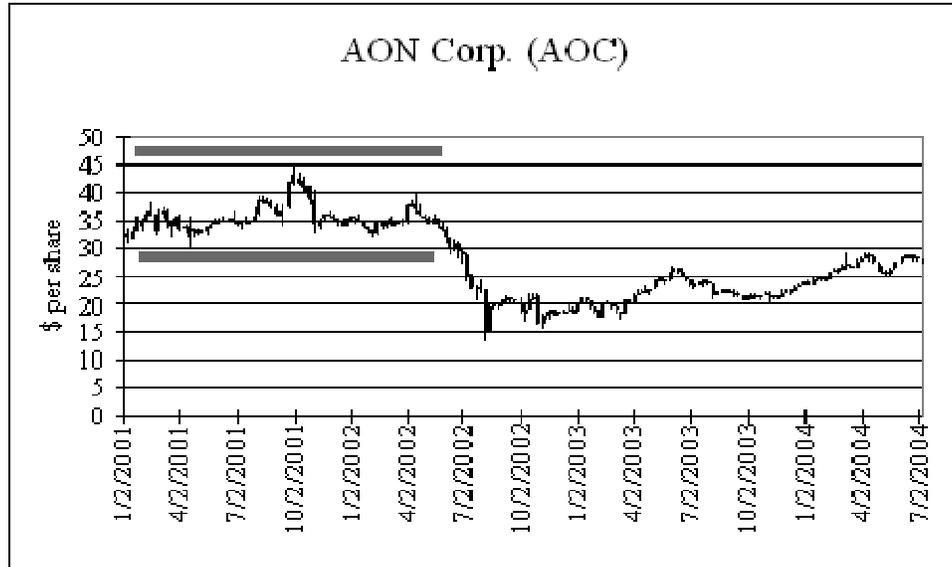
*How to Find a Home Run Stock by John Lux*

2. A price going up is a price going up. Price going up looks like this:





3. A price going sideways is going sideways. Price going sideways looks like this:



Always remember --

**The trend is your friend.**

\



*How to Find a Home Run Stock by John Lux*

4. A price in motion tends to stay in motion. Price going down tends to stay going down, up tends to stay going up. Sideways tends to stay sideways.

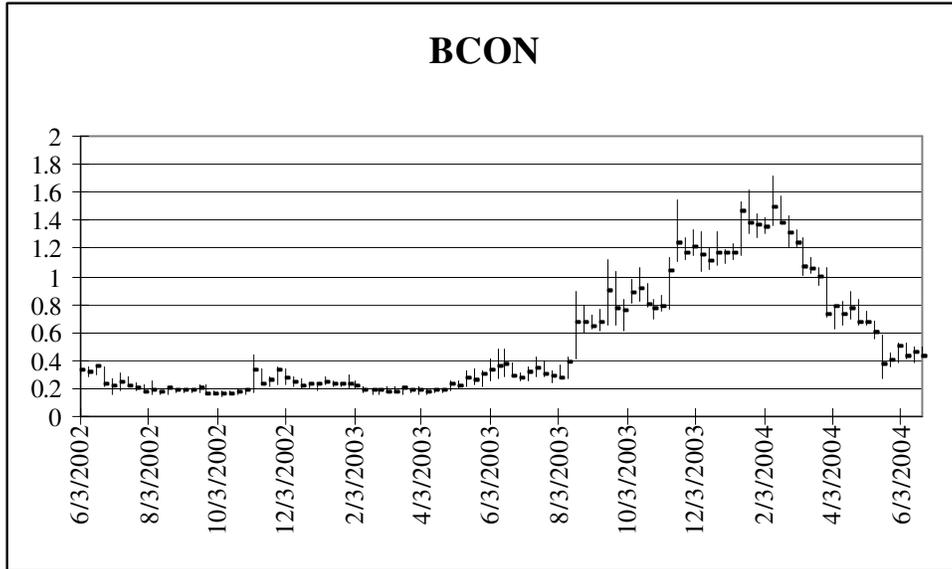
In other words, the price is going up until the price goes down or sideways. Price goes up until it goes down or sideways, goes sideways until it goes up or down.

**The trend is your friend.**

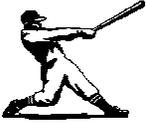


*How to Find a Home Run Stock by John Lux*

5. A price that has changed motion has changed motion. If a price is going sideways and starts to go up, then it has changed into going up. Like this:



\

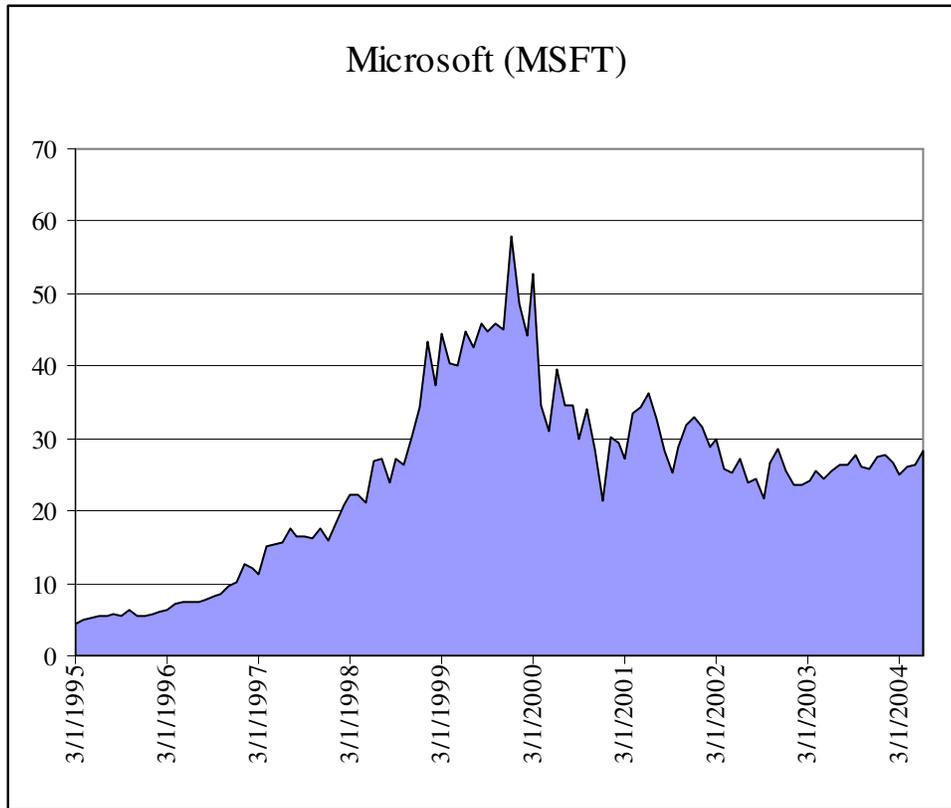


*How to Find a Home Run Stock by John Lux*

6. Do not trade until the price is going your way. When the price goes against you, do not ask why, just get out immediately. You will only find out why the price went against you later, when it is too late to get out. When the stock is weak on good news, be careful. When the stock is strong on bad news, wonder why.



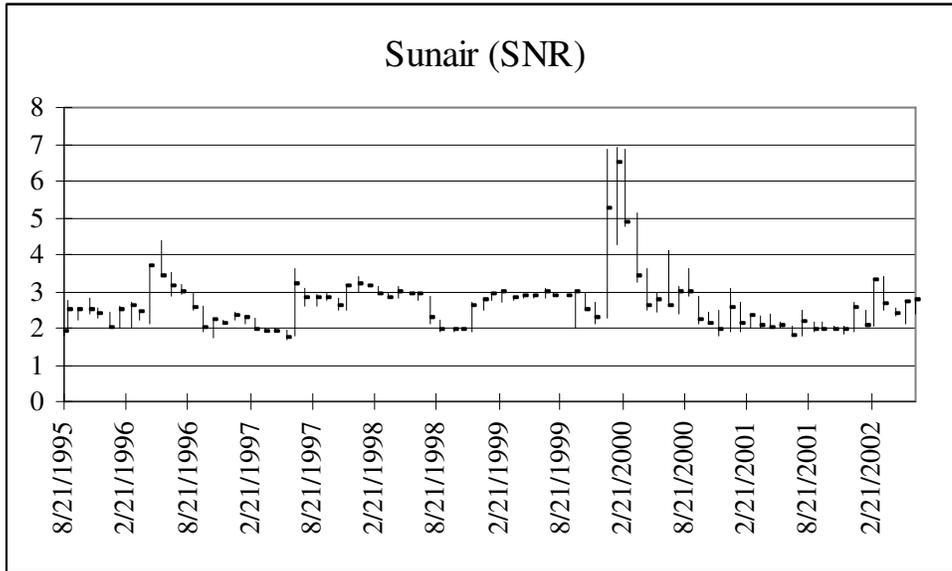
7. A stock can go into a buying or selling panic. This is usually indicates a reversal in movement. A buying or selling panic usually occurs at the end of a long move up, for a buying panic,





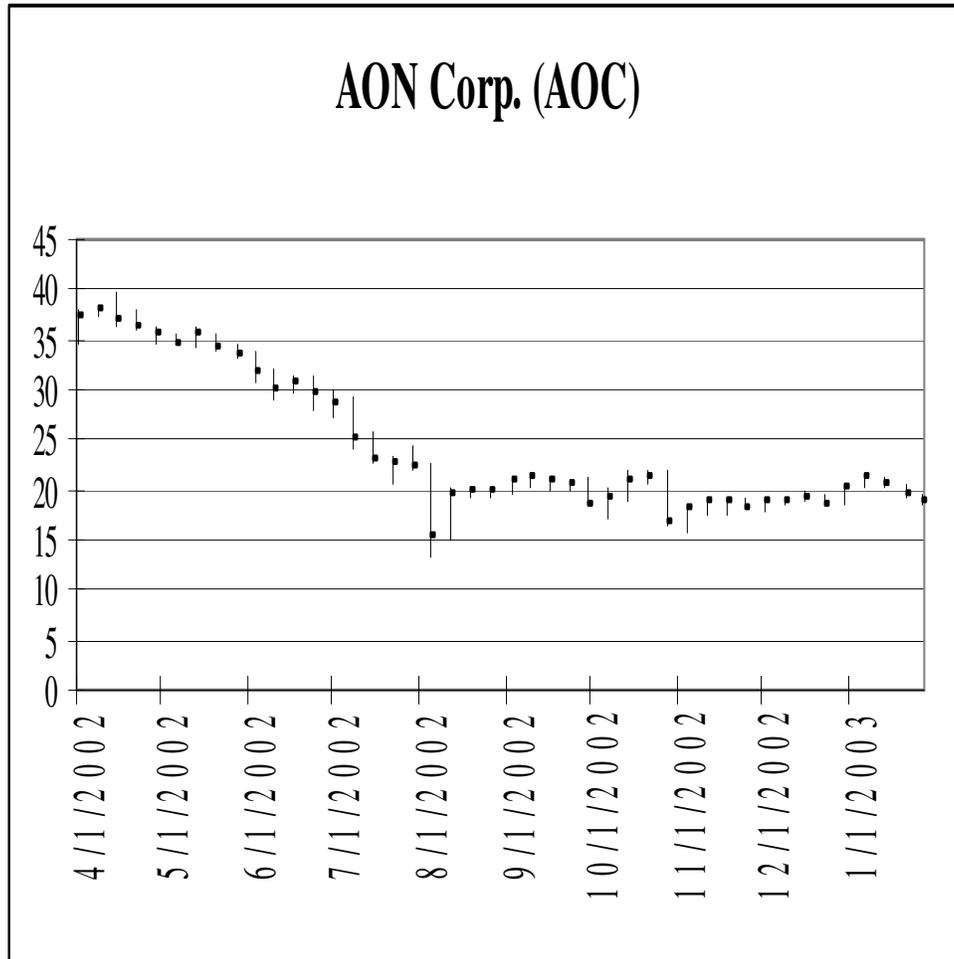
*How to Find a Home Run Stock by John Lux*

But not always . . .





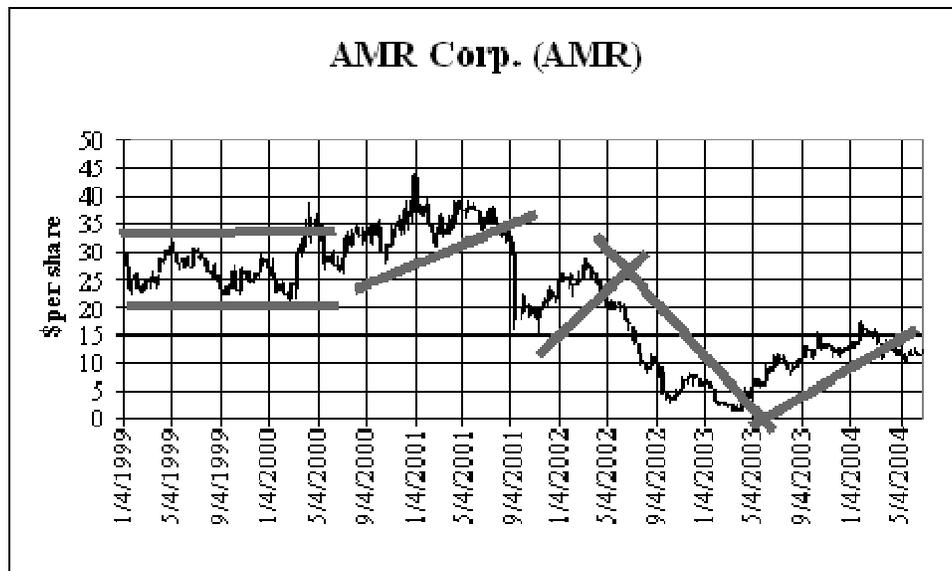
or a long move down, for a selling panic. Selling panics look like this:





## Drawing Trendlines

Draw trendlines on charts in the conventional way. Your stock might not be moving up right away, but when it does, start drawing in trend lines. Each trend channel has support and resistance lines. They will look something like this:



For some reason, I have had the best luck with a 45 degree angle support line in an uptrend on charts.



*How to Find a Home Run Stock by John Lux*

If you have had some experience in trading the stock market, and are evaluating this information, you have probably just realized that the basics are very important, easy to state, hard to do, and that successful implementation of the basic principles yields enormous rewards.



*How to Find a Home Run Stock by John Lux*

**When to Sell**

There are two times you should consider selling. 1. When the stock breaks a support line of an up trend (point 1 in the next page). 2. When the stock spikes out of the top of an up trend resistance line (point 2).



*How to Find a Home Run Stock by John Lux*

## **The Basic Pattern of Price Movement**

This is probably the most important part of the book. I urge you to give this section the strongest possible attention.

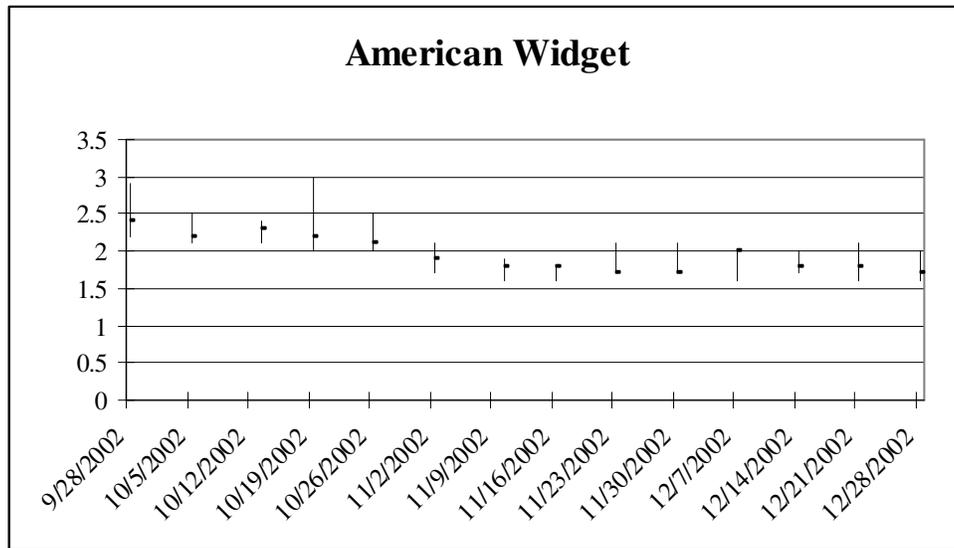
With this information alone, you can make money. Added to the rest of the book, you can look forward to some large paydays.



*How to Find a Home Run Stock by John Lux*

The basic pattern of price movement is best illustrated by an example. Please pay close attention and remember this pattern -- this is important!

At the beginning we have a company, American Widgets. The stock is going sideways and sells at a low price in relation to the company's value of \$5 per share.



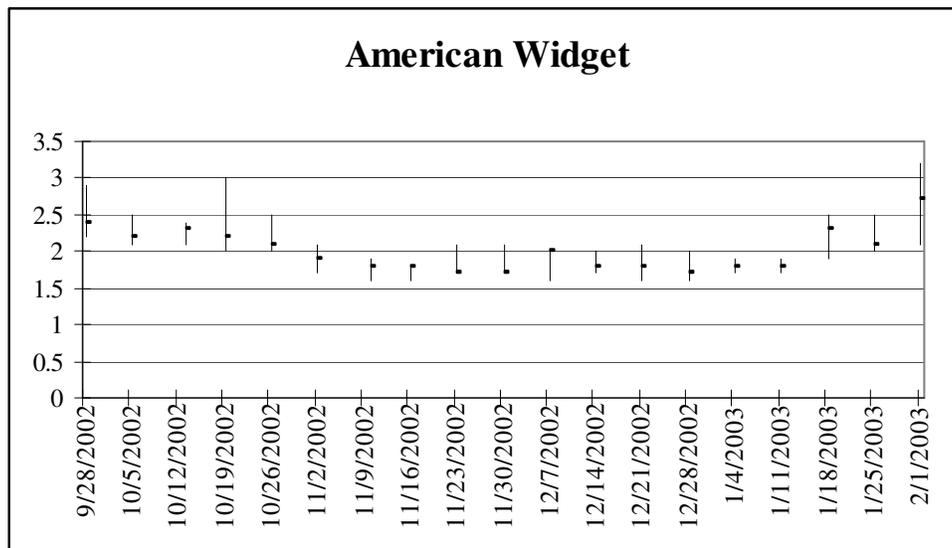


*How to Find a Home Run Stock by John Lux*

One day, workmen are digging a hole in the basement of American Widget's corporate offices. The hole is for the executive swimming pool. The workmen strike oil.

The first people to find out are the corporate officers and directors. They will be the first to buy. Of course, in our hypothetical example, they would be barred in buying by the insider trading laws. However, let us suspend these laws for purposes of our example.

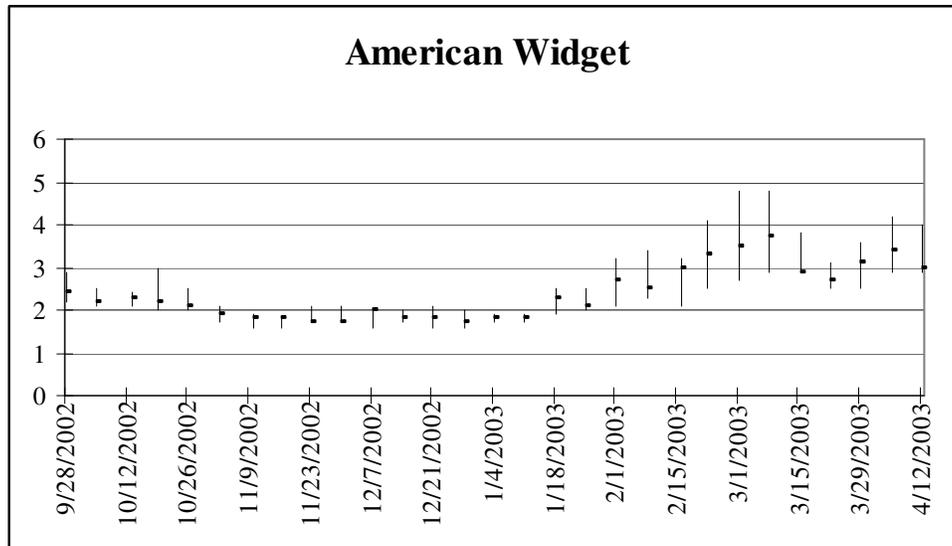
Because of this buying, the dull volume in American Widget would pick up somewhat. The insiders, if they were smart, would slowly accumulate a large position in the stock. This would inevitably affect the volume and price. The stock is now \$3.





*How to Find a Home Run Stock by John Lux*

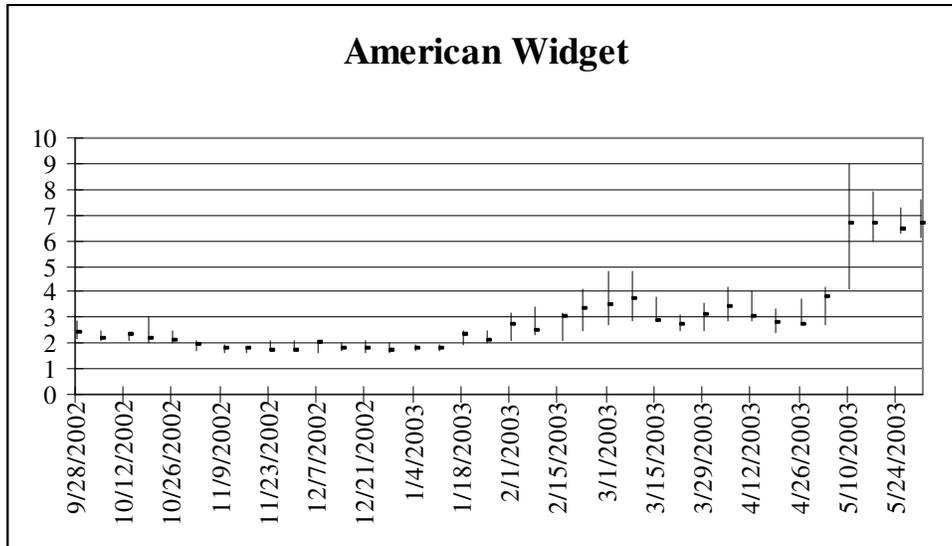
In the next stage of activity, those close to the company find out. The insiders' relatives are buying. The brokers close to the insiders would sense a good thing by watching the activity of the insiders. The investment bankers close to the company might become aware of the new value of American Widget. The stock starts trading on moderately light volume and reaches \$4.





*How to Find a Home Run Stock by John Lux*

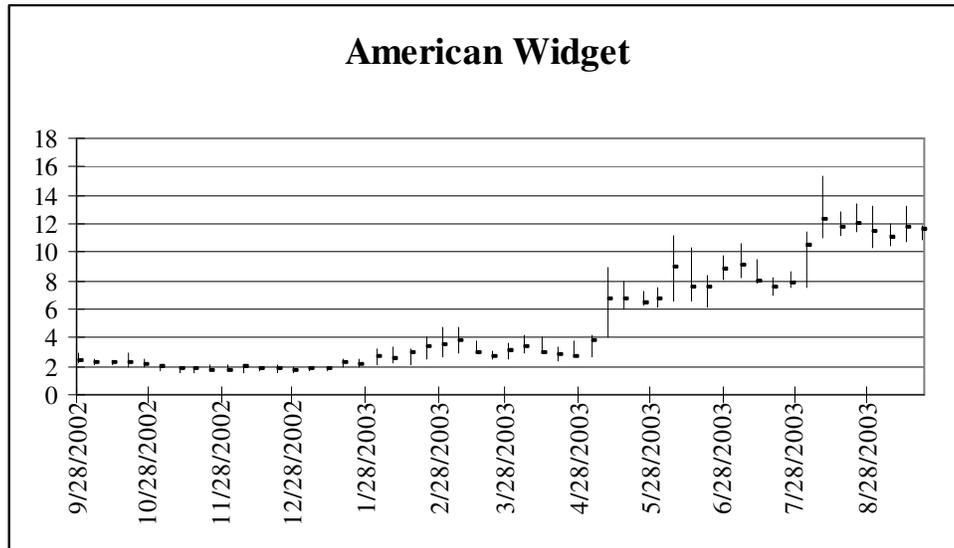
By now the astute chart trader has noticed that the price is up. He buys. Analysts start recommending the stock. Some newsletters pick it up. The price reaches over \$8 on more than moderate volume.





*How to Find a Home Run Stock by John Lux*

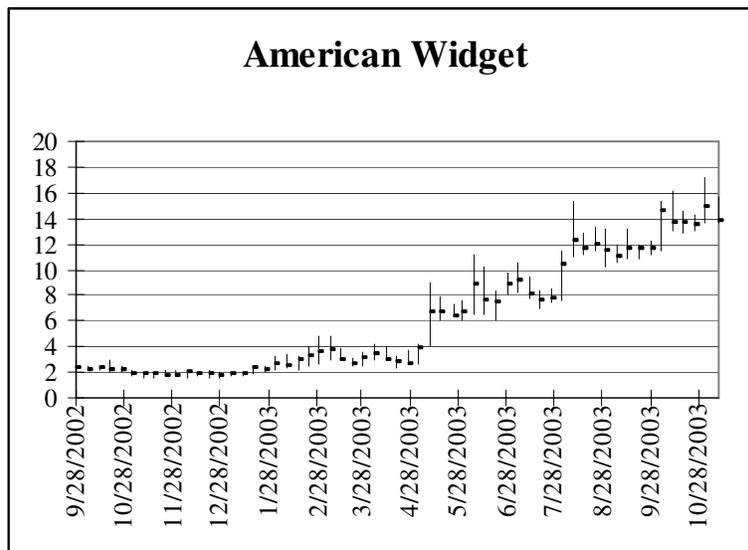
In the next phase, the word reaches the general broker and he calls his clients. The stock reaches \$12 on good volume.





*How to Find a Home Run Stock by John Lux*

Finally, the news reaches the Wall Street Journal, FNN, and the Nightly Business Report. The general public is aware of the news. The stock peaks at \$17 on heavy, erratic trading. All those who might act on the basis of the news have received the news. There is no new news and no new buyers. The ripple started in the center of the pond and expanded until it reached the edge of the pond. Naturally, the ripples stop at the edge of the pond and the new money stops coming into a stock when everyone knows the good news.

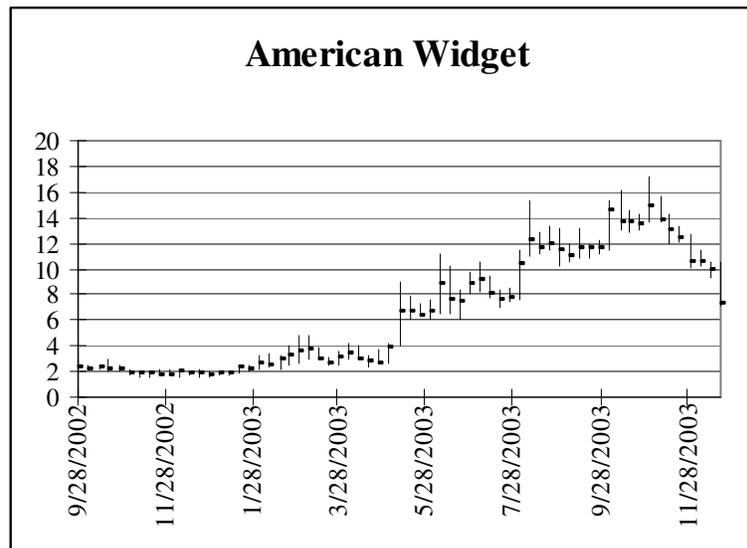




*How to Find a Home Run Stock by John Lux*

Realizing this, and having seen the stock rise about 800%, the insiders start selling. The stock is still trading on strong volume because it has received a lot of public attention. Brokerage firm newsletters and probably other newsletters regularly mention the American Widget. The price reaches \$8 and lower.

When the price gets to the \$8 range, new buyers show up.



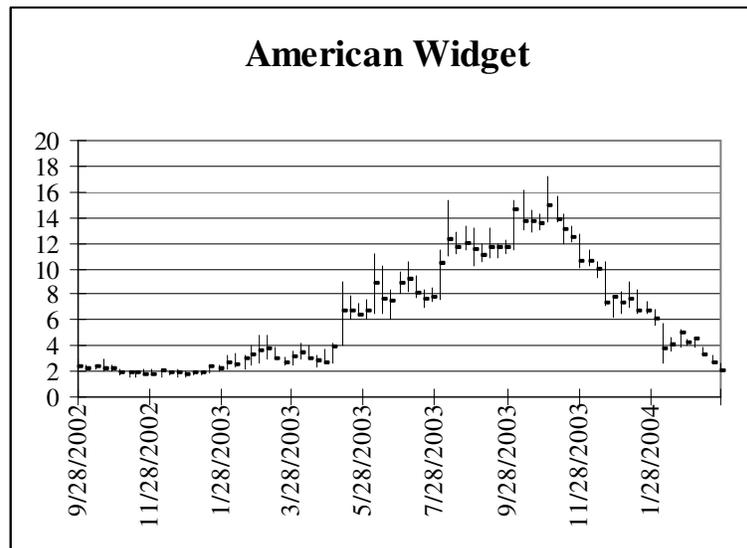
They are acting on the philosophy “This used to be a \$17 stock, now it is \$8; therefore, it is a bargain.”



*How to Find a Home Run Stock by John Lux*

On the way down, the stock trades on heavier volume than the way up.

When the news comes out that the oil find was really a workman hitting someone else's oil pipeline, the stock hits \$2, its original price. It will go lower, as insiders continue to sell and some of those who bought at \$17 sell. The rest of the losers will continue to hold until the price gets back to where they are breaking even. This may take five to ten years.



Looking at this overall cycle, we see that a small number of large buyers accumulate the stock. The market then marks up the price of the stock. The small number of large holders then distribute the stock to a large number of small holders.

The flow of a stock's price follows the flow of information.

It is important to remember this pattern. You can look at the action of the stock and the information you have and discover whether the stock is going up or coming down.



*How to Find a Home Run Stock by John Lux*

**What kinds of information do you yourself act on?**

**Who gives you this information?**

**How successful has this been?**



*How to Find a Home Run Stock by John Lux*

When you receive information about a stock, you must consider:

1. the information,
2. who is giving you this information, and
3. where in the pattern the stock is.

Thus, if an insider gives you a tip and the stock has been going sideways on low volume but is starting to increase slightly in price and volume when the stock is cheap in relation to its value, you may assume that you have just received some valuable information. If the stock has just tripled, sells way above its value and trades on heavy volume, you may assume that the same insider wishes to encourage you to buy so he may sell into your buying.



*How to Find a Home Run Stock by John Lux*

We are now going to trace the trading activity of one stock over a period of twenty years. This will show you how the method works in practice.

I have chosen for you the stock of a well known company, Merrill Lynch, the large securities broker.

The stock symbol for Merrill Lynch is MER.

I will show you a period of trading activity for MER. I will comment on the picture presented and apply the method. We will then turn the page to see if our predictions were correct.

This will show you how the method is applied and give you confidence in the method.

First a comment on the stocks of stockbrokers. Stockbrokers are in a cyclical industry.

Based on historical observation, I would expect that brokerage stocks will sell in a range from one-half of book value at the very lowest to 2-3 times book value at the most.

The PE ratio would be unlikely to get below 4 in any brokerage stock.

Let us begin – turn the page



*How to Find a Home Run Stock by John Lux*

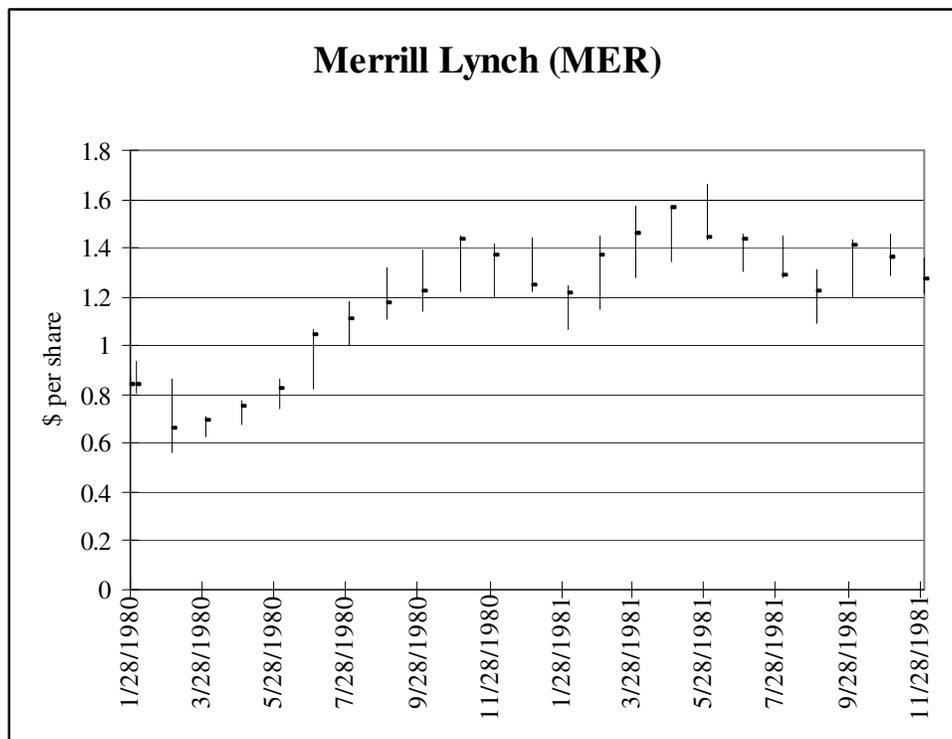
Please note as we do this study, MER split several times throughout this period. The prices we are using are the prices adjusted for the splits, not the original historical price.

We begin with two years of trading in MER at the end of 1981.

In 1980, the low was a P/E ratio of three and a price of \$0.98 compared with a book value of \$1.63. This would obviously have been a good time to buy.

In 1981, the P/E low was 6, and the stock barely made it below book value.

As we begin on January 1, 1982, MER is \$1.29, book value \$1.88 with a PE of 4.



This is below book with a tasty PE ratio – a possible buy. We would therefore for wait for an upturn in the stock.



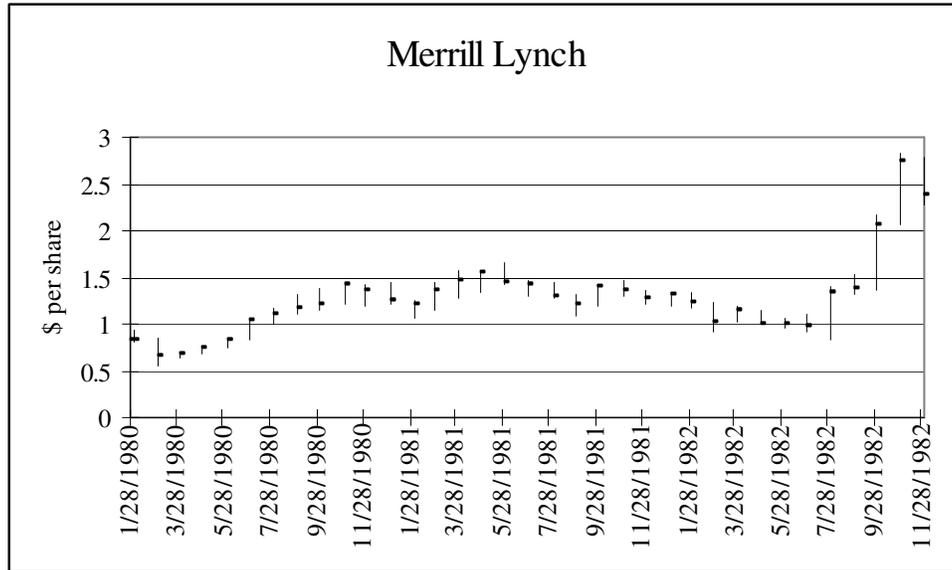
*How to Find a Home Run Stock by John Lux*

Go to the next page to see what happens next.



*How to Find a Home Run Stock by John Lux*

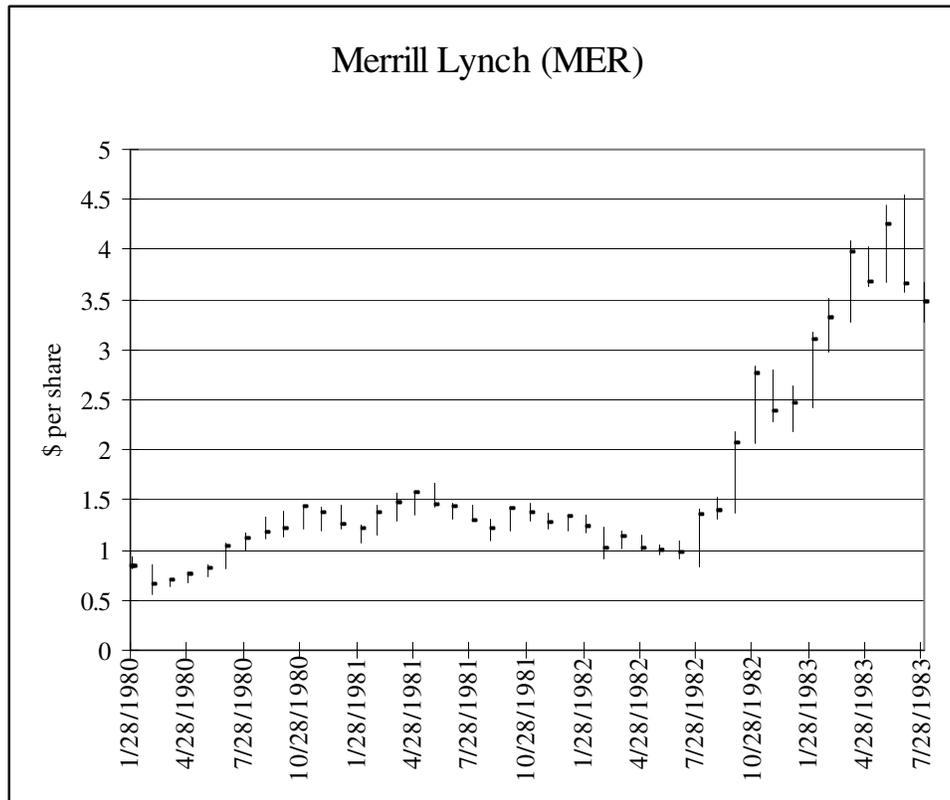
In September, 1982, MER moves up and breaks its downtrend. We buy, probably about \$1.88.



Let's see how we did.



Into 1983, MER is still climbing wonderfully. By mid-1983, MER breaks our uptrend line. We sell, probably about \$5 or higher.



We bought at \$1.88 and sold at \$5, making a gain of about 3 points or 166% in less than one year.

Since MER trades on the New York Stock Exchange, MER is marginable, so we could have increased this profit percentage by using leverage.

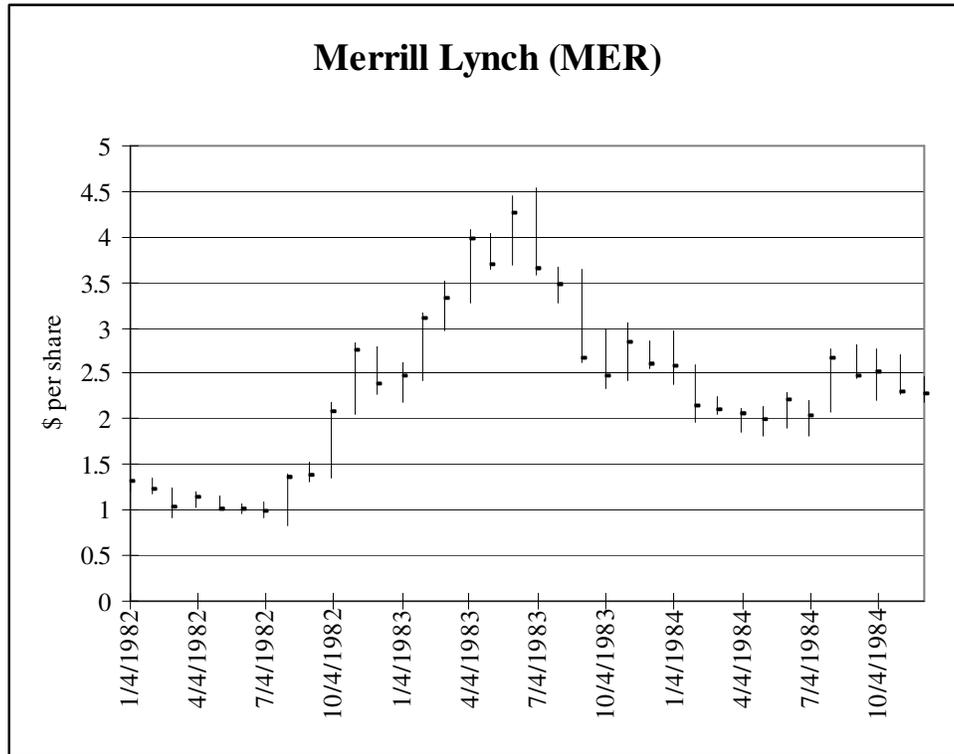
Because Wall Street is a one-way street, we ignore MER until it drops below book value again.

Let us see when that is.

1984, and MER sells just below its book value of \$2.70. The PE is 21, so we pass.



*How to Find a Home Run Stock by John Lux*



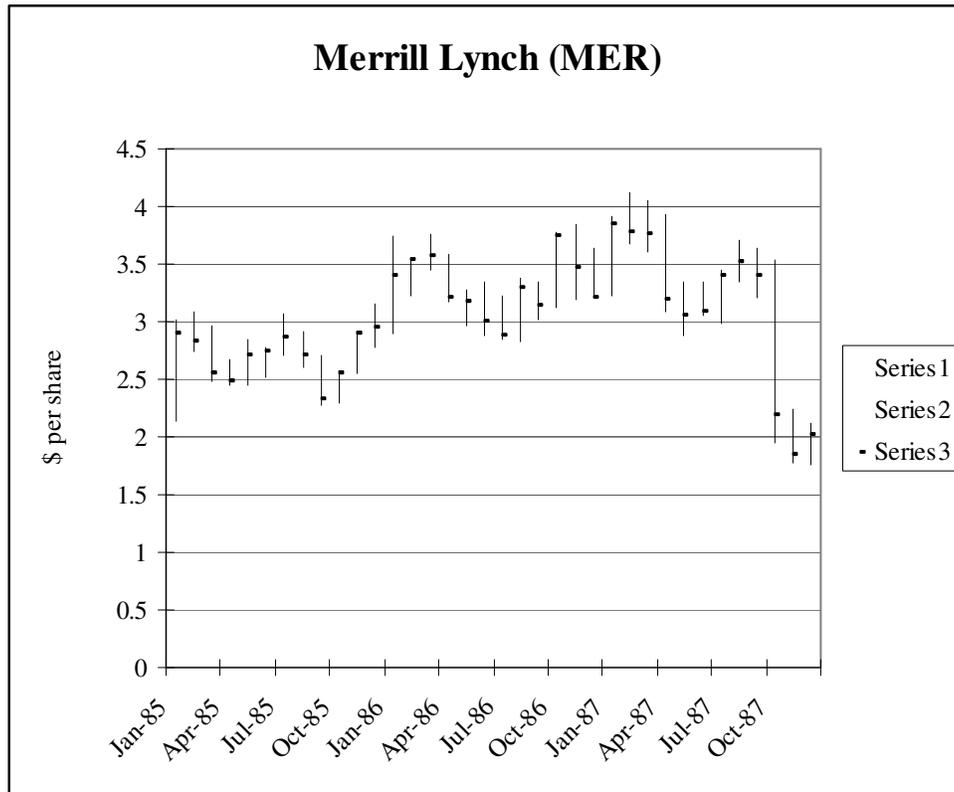
Next . . . .



You remember 1987? Until August, the stock market went wild on the upside.

The market then slid rapidly into the crash in October.

MER with a book value of \$3.70, drops to the \$ 2 range, giving it a PE of 5.





*How to Find a Home Run Stock by John Lux*

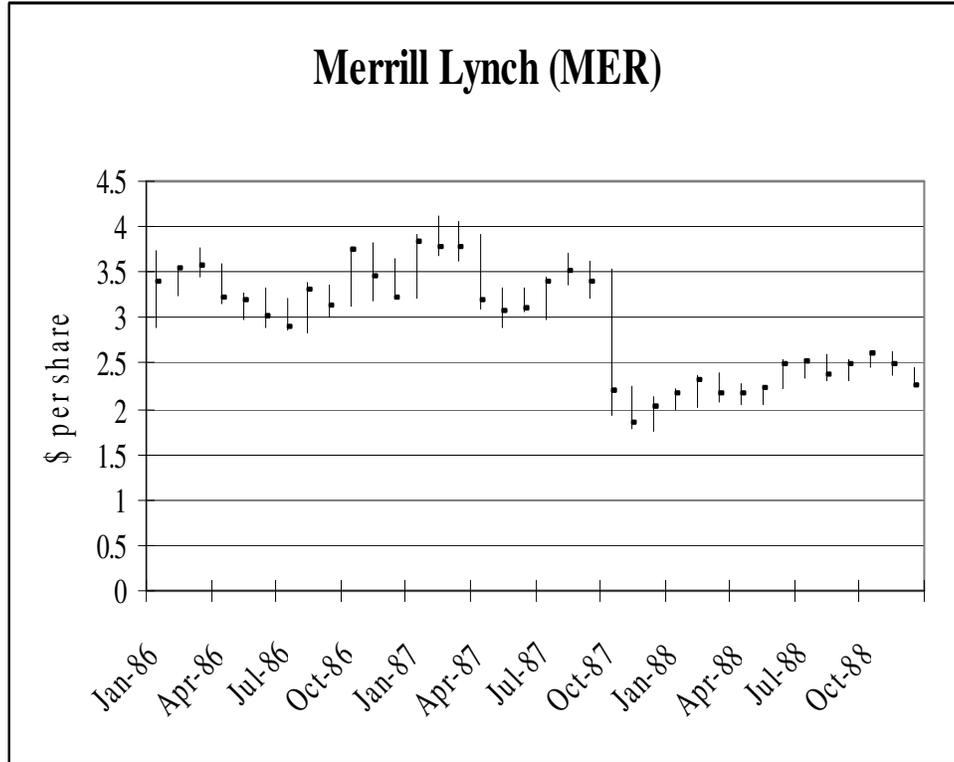
Most investors were in shock at this point and didn't want to talk to their broker. If you lived in Palm Beach, Florida the Sunday after the Crash, you might have heard some nut named John Lux on the radio telling you to buy, that this was the best buying opportunity we were ever going to see. (One guy called in from this interview and he didn't buy anything.)

If you had the guts, you put in your trend lines and bought, probably in the mid to low \$2 range. Let us call it \$2.4. (I did not buy MER, I bought General Electric and Ford right after the crash because they both had huge amounts of cash. This reduced any possible risk.)

How did you do?

Following the trend line, at the end of 1988, you would have sold out when MER sank, probably selling at about \$2.60. Less than one point in one year, for a return of 18%.

Unless you noted that MER was still well below its book value with a PE of 6 and hung on.

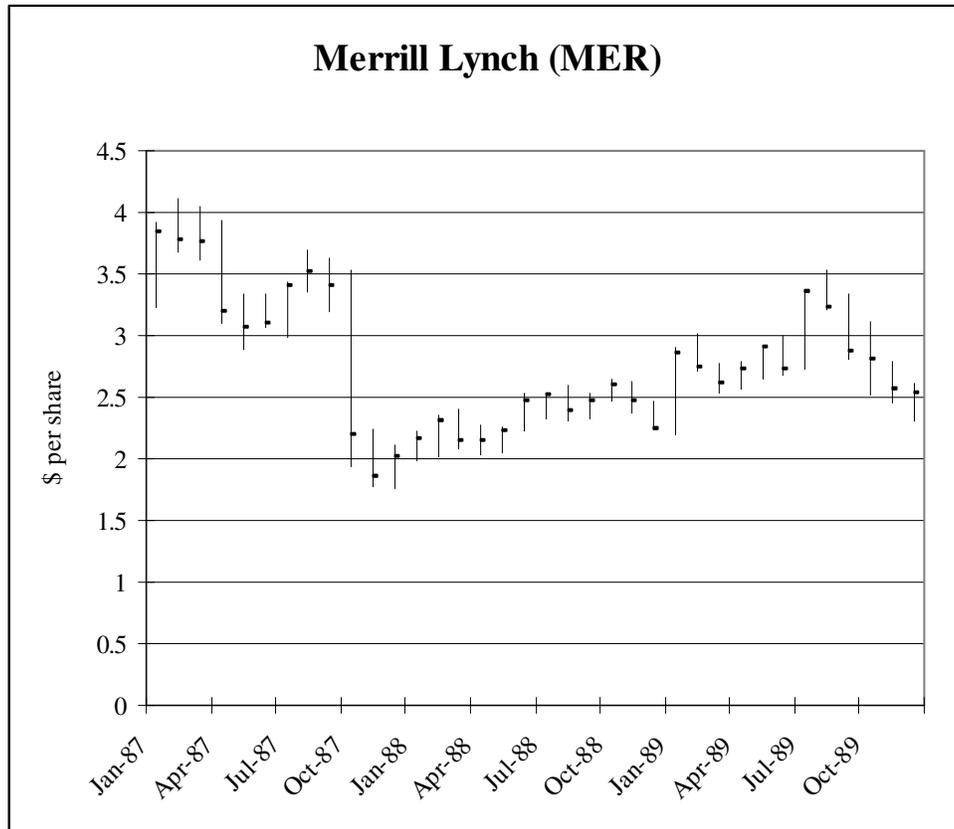


Or you might have bought at \$2.40 again.

Result?



MER spikes wildly in 1989. Let us be conservative and say that you would have sold at \$3.40, although the stock went over \$3.50.



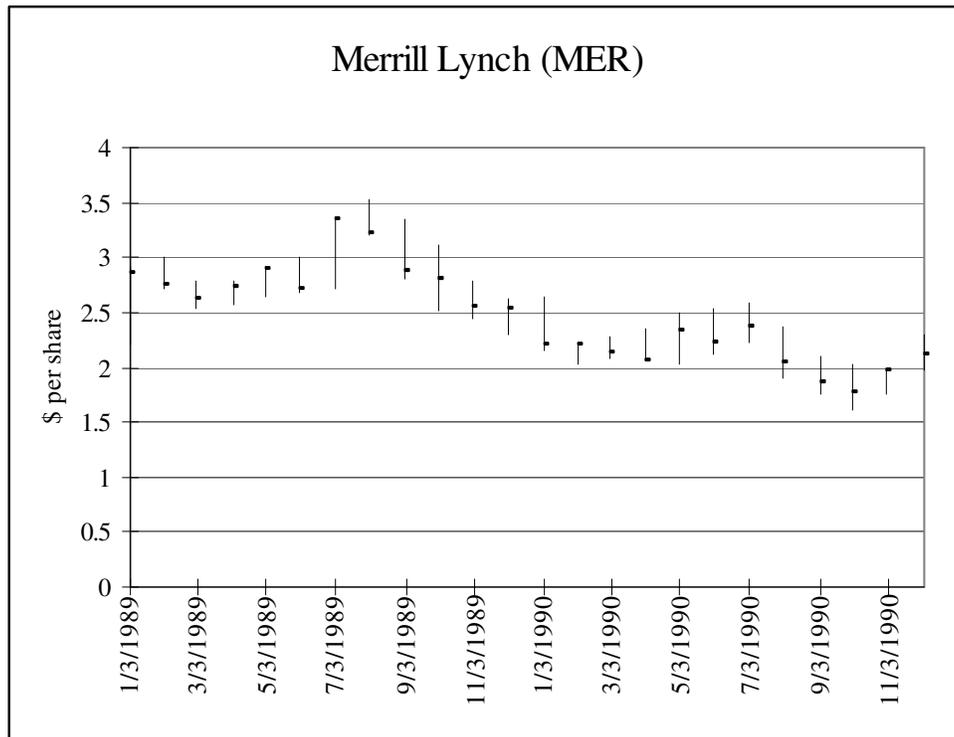
This is a gain of \$0.85 on a buy at \$2.50 or 25% in one year.

But wait, there is more!



*How to Find a Home Run Stock by John Lux*

In 1990, MER sinks to a low of \$1.65 while book value is \$2.90. PE is 10.

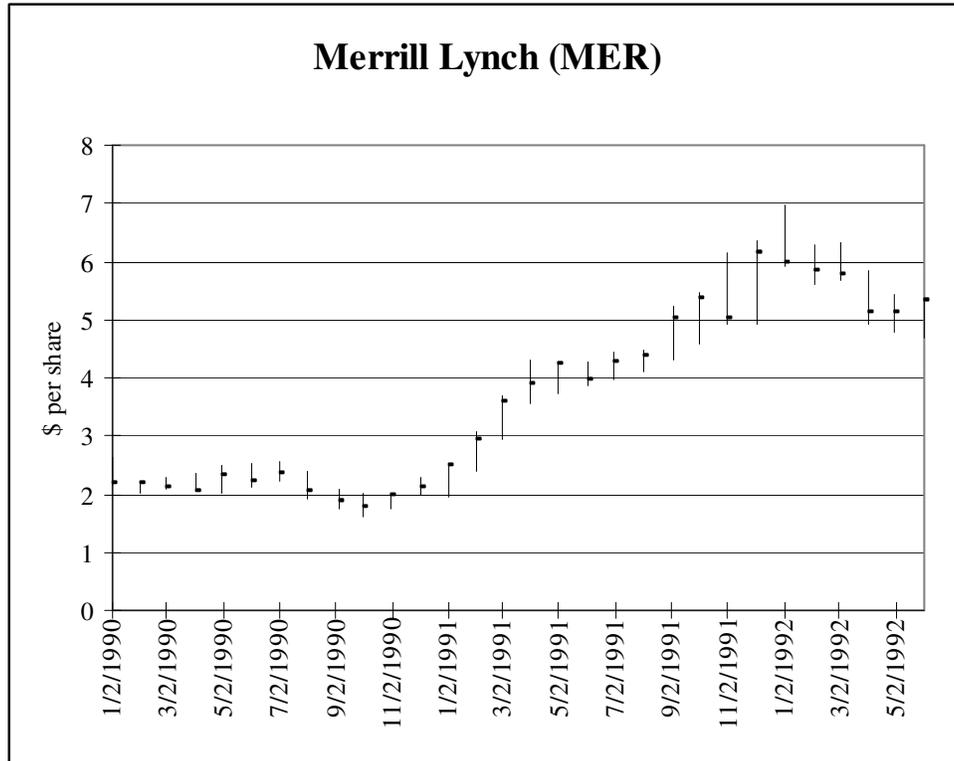


We buy at below \$2, say \$1.70.

How did we do?



Wow! MER goes into a wild climb. Following the trend line, we are out at about \$4.25.



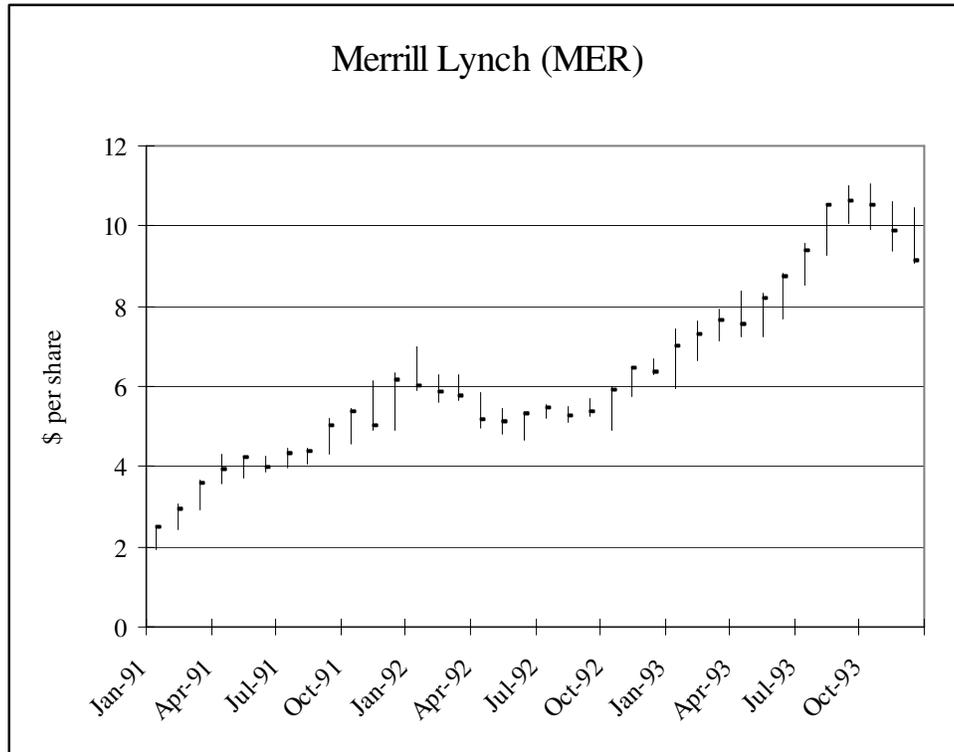
From \$1.70 to \$4.25, a gain of 150% on our money in under 18 months.

We are starting to like this stock. When can we play again?



*How to Find a Home Run Stock by John Lux*

MER drops somewhat, but is certainly not a buy, but then climbs even more to over \$10 in 1993 and splits 2-1.

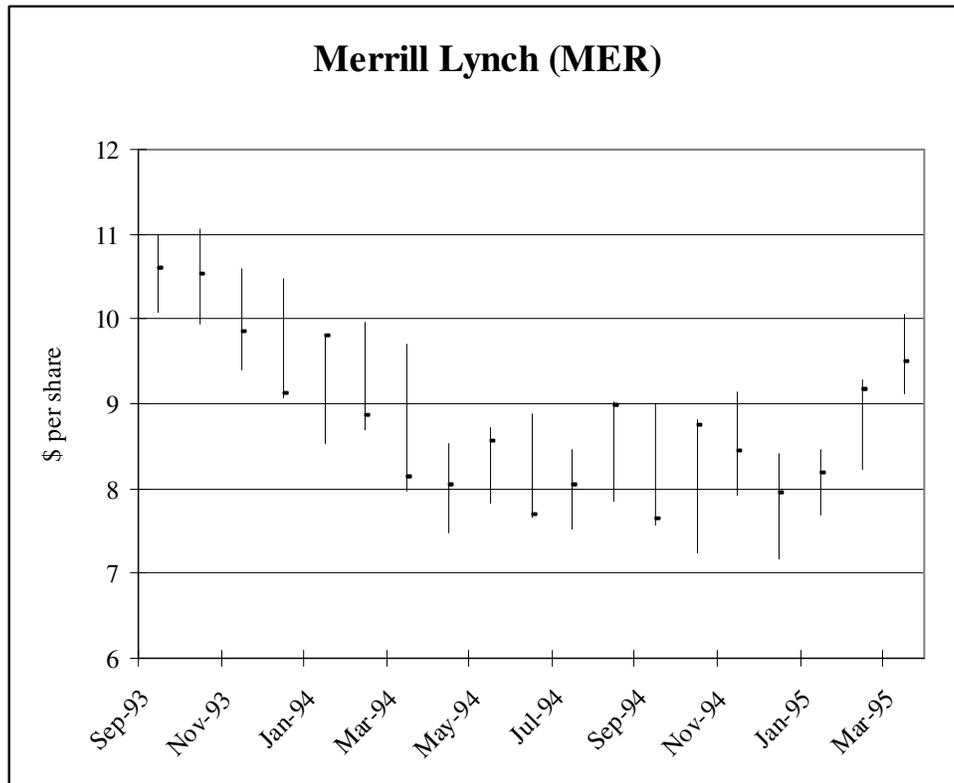


Anybody want to buy the split?

Not us. Next page.



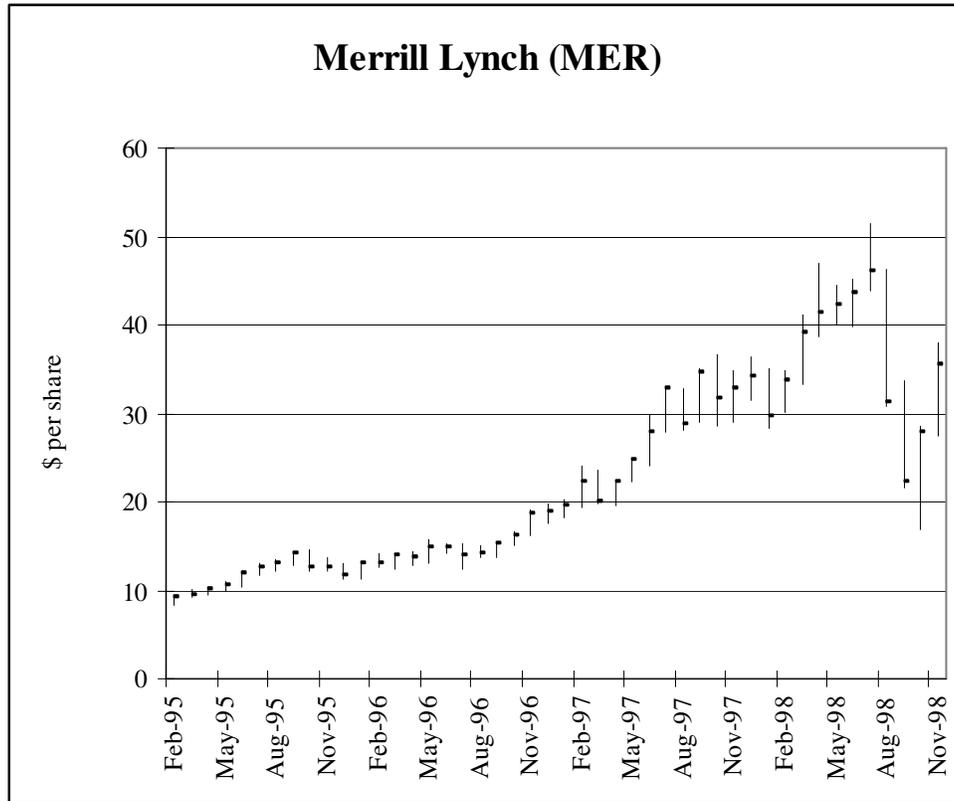
MER comes close to its book value in 1994-5, and the PE is 6.



Not cheap enough for my money, but it is the start of an up move in MER.

MER splits 2-1 in 1997. (Note that we are now using a different price scale.).

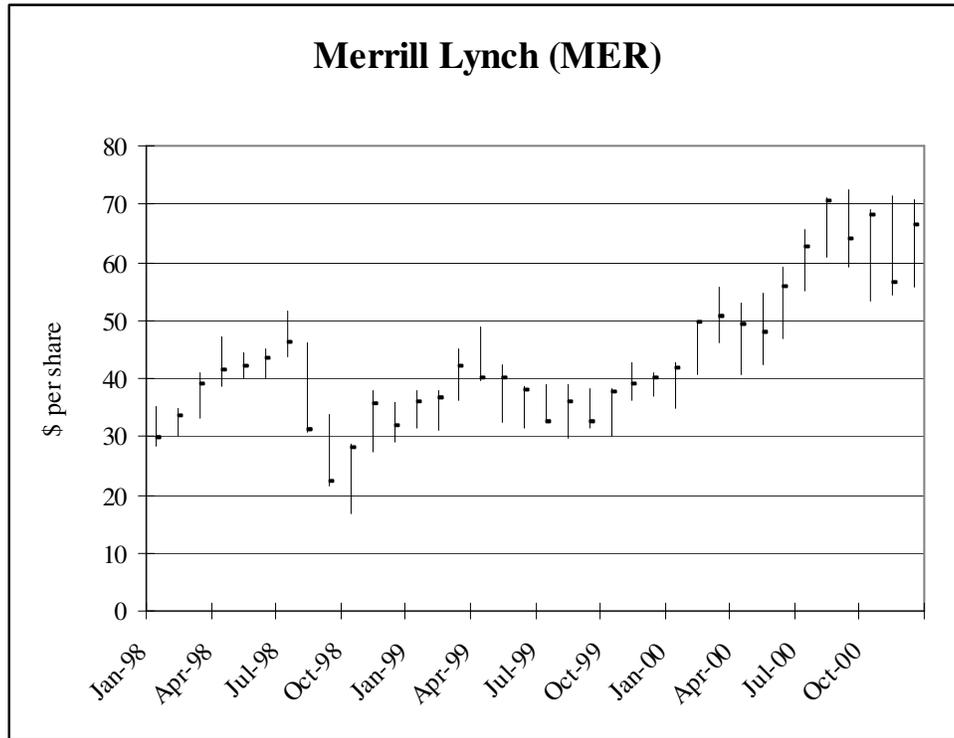
MER peaks at over 50 in 1998.



Then by October, 1998, MER is back to a low below \$40.

However, MER is still not cheap enough to fit our rules.

We move on.



MER peaks at the beginning of 2002 at \$59.

MER sinks to a low of \$28. Still not a buy in my mind with a book value below \$20, but the stock has rebounded as of this writing to \$40.

Let us see how we did.



Here is our table of results for our paper trading in MER: (Note: we are using un-split prices in some cases.)

<b>BOUGHT</b>	<b>SOLD</b>	<b>MONTHS</b>	<b>POINTS</b>	<b>GAIN</b>	<b>ANNUAL GAIN</b>
Sep 1982 \$15	Aug 1983 \$40	11	25	166%	166%
Oct 1987 \$22	Nov 1988 \$26	11	4	18%	18%
Dec 1988 \$24	Dec 1989 \$30	11	6	25%	25%
1990 \$20	\$55	18	35	175%	116%
	<b>Total</b>	<b>51 months</b>	<b>70 points</b>	<b>384%</b>	<b>81%</b>

Well, there you have it folks, an average annual gain of over 80% in a large New York Stock Exchange company that is certainly closely followed by Wall Street. You could have almost doubled that return using margin. You should be able to get much more in little-known, small-company stocks.

Your risk is relatively low, considering we never paid more than the company's liquidation value. MER was also rated B or B+ by one of the leading ratings agencies during this period.



*How to Find a Home Run Stock by John Lux*

So if you follow my methods closely, you can achieve returns that are much higher than the market returns with low risk. If you are like me, you see here that you can predict stock market activity and make money. We are not throwing darts at the newspaper to select stocks.

You can compete effectively with the professionals if you do exactly as I say. After all, the public and the professional brokers and analysts at MER and their competition in the brokerage business should be following MER stock closely. The market in MER should be efficient if the market in any stock is efficient.

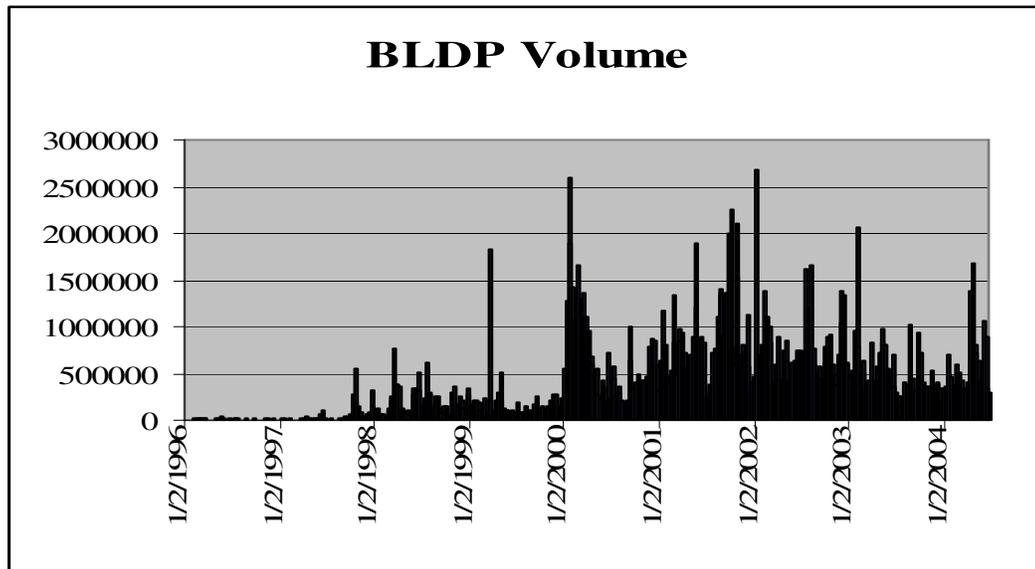
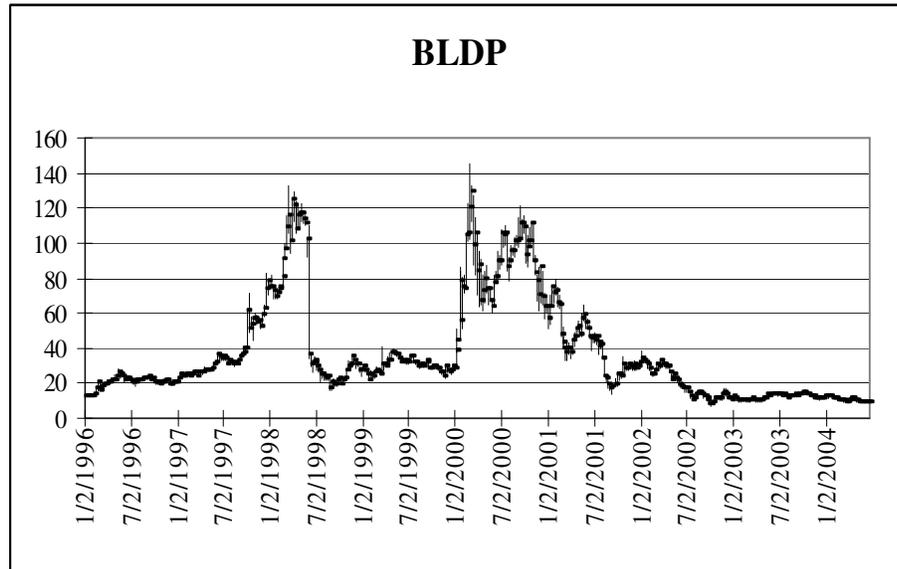
P.S. Congratulations, my friend, we have just made short work of the Random Walk and Efficient Market theories.

Let' go on to look at some more stocks.



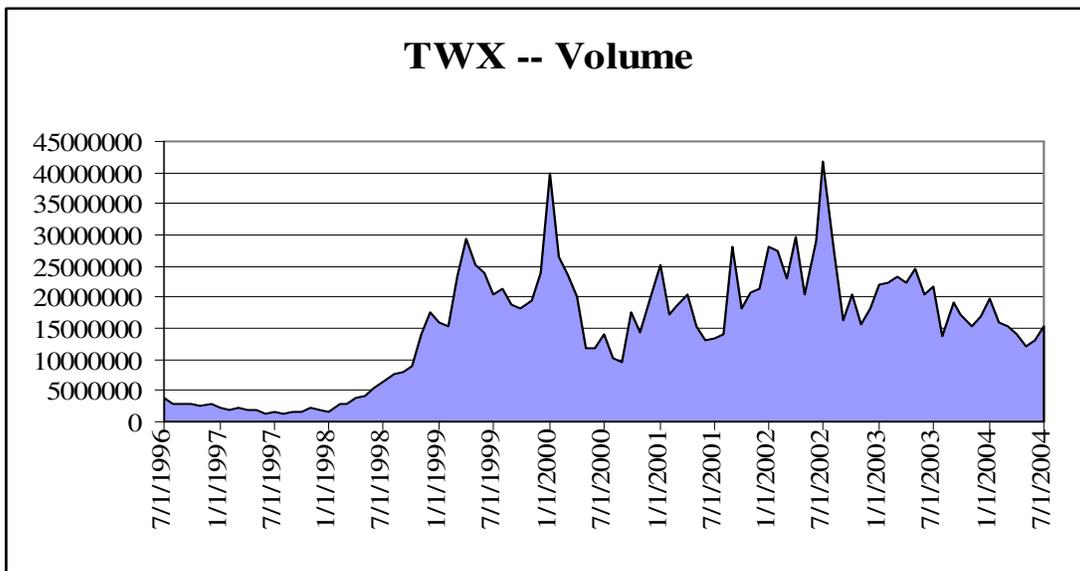
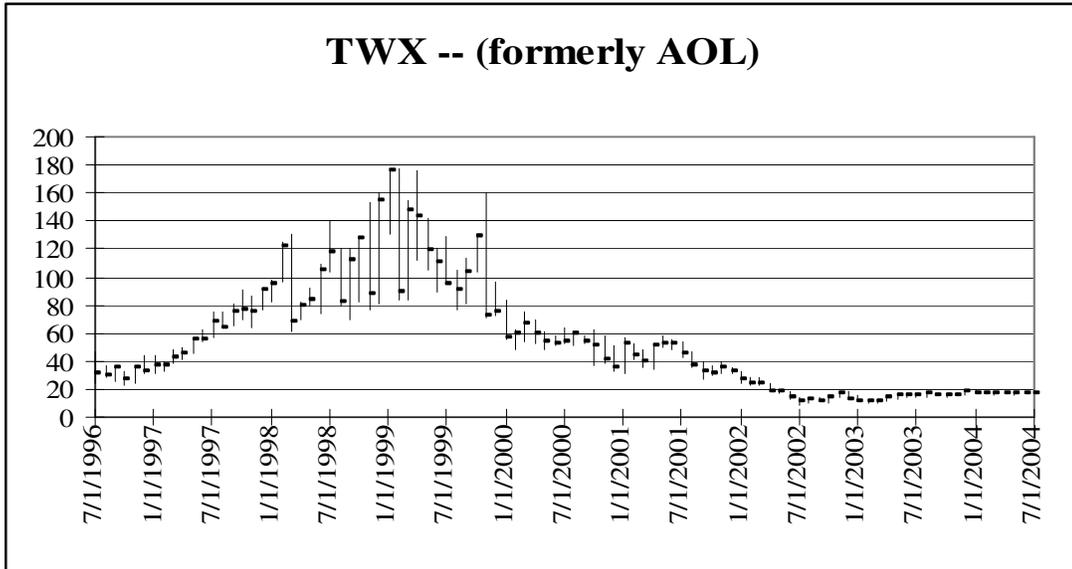
*How to Find a Home Run Stock by John Lux*

Here are some stocks illustrating the pattern of stock prices. Here is one, Ballard Power.





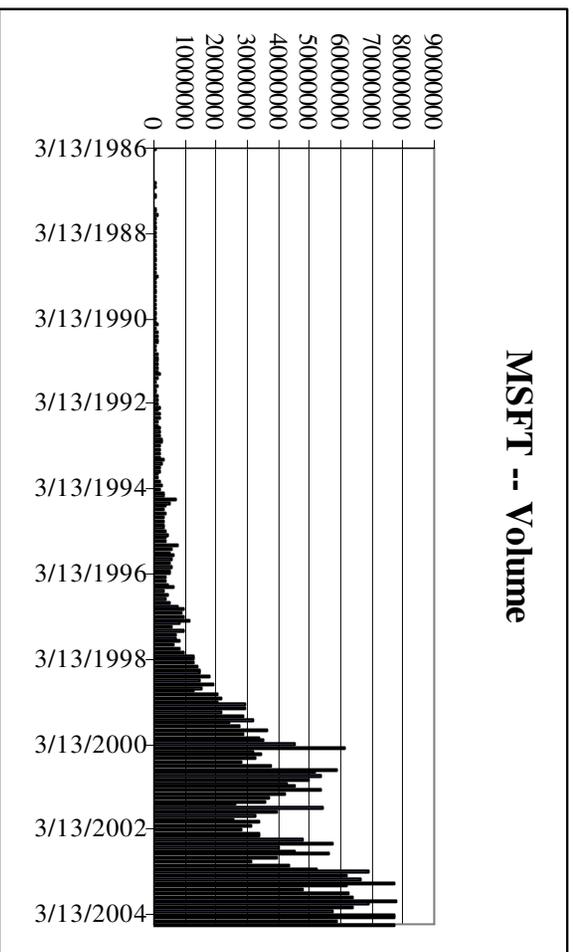
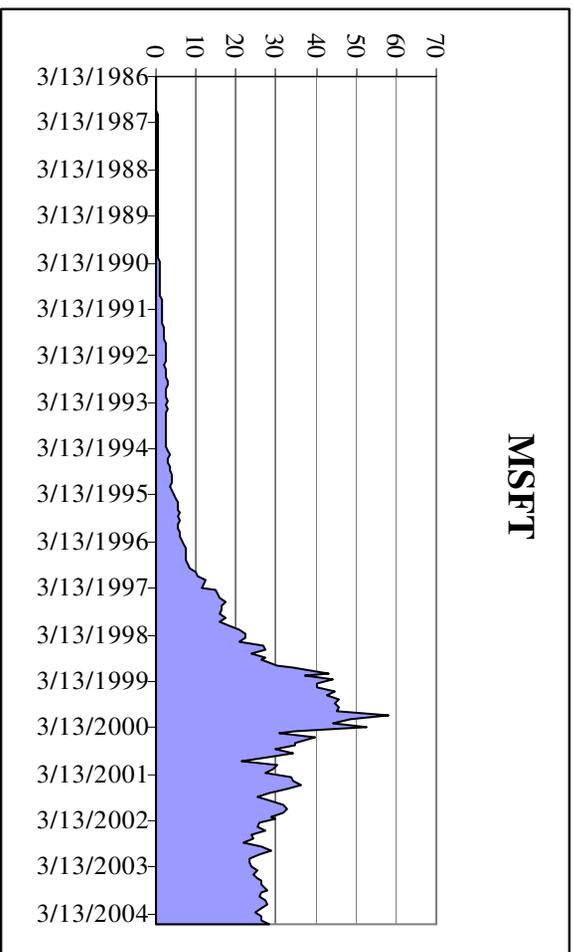
This is Time-Warner, formerly AOL.





*How to Find a Home Run Stock by John Lux*

This is Microsoft:





*How to Find a Home Run Stock by John Lux*

### **Trading -- How to Chart Stocks**

You must use stock charts. Use a ruler. When you have selected an underpriced stock that is going sideways, draw a line over the sideways pattern. When the stock breaks this line, buy.

As the stock goes up, draw an up line under the uptrend pattern. I find that my best lines are about a 45 degree angle. When the stock breaks this line, sell.

The rules are the reverse for short sales.

That is all there is to that. It can be that simple.

Next I will give you some sample charts



*How to Find a Home Run Stock by John Lux*

**Do you prefer large, blue chips or small cap stocks?**



## **Large Companies**

Sometimes people think that my methods are only good for finding small companies. This is untrue. In fact, I work mostly with small companies because the potential for increase in a small company is smaller than the potential for increase in a large company.

To take it to extremes, it is unlikely that General Motors will have a ten-fold increase in car sales this year. However, if my daughter, Heidi, works hard at her lemonade stand, it is possible that she may increase her sales from \$5 to \$50. A small company has room for a large increase in its market share. A company with a substantial piece of the market will have trouble growing faster than the market itself.

A good example of this is a leveraged buyout we did in the summer of 1990, Sawell, Inc. Sawell makes saw blades. The construction industry uses Sawell's saw blades. Shortly after we closed the deal, the market for housing and other types of construction collapsed. Sawell, however, continued its 50% per year growth rate because it has brilliant management, superior marketing, and a superior product. In one year the company had to move to larger quarters and was working evenings and weekends to keep up with demand. The President of the company was a finalist in Inc. Magazine's contest for entrepreneur of the year.

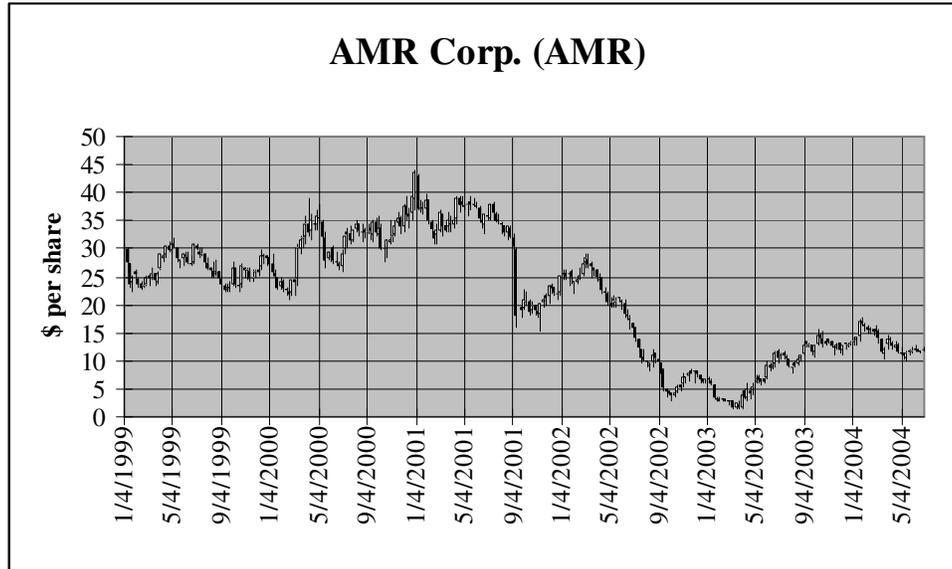
Nevertheless, these same principles of investing apply to large companies. In the summer of 1984, we bought Celanese. We read about it in Value Line. It was a large company. Celanese was selling below book value, had an RMV of 5 and a low P/E. We bought Celanese near the years low in the 60s. Less than two years later, a German firm bought all of Celanese at \$240 per share.

American Telephone and Telegraph at one time was a "formula stock." A formula stock is my term for a stock that fits my formulas. In 1984, American Telephone traded at a relatively low P/E and close to book value. Given its wide attention as an institutional stock, and the fact that it was listed, I felt that these ratios would not get much cheaper. By 1987, the stock hit 35 7/8, paying a high yield all the way.



*How to Find a Home Run Stock by John Lux*

In the last two years, AMR Corp. went to a low of 1 5/8. At that price it was way below book value and was down from a high of over \$40 about two years earlier.



As you can see, the AMR went up ten times from its low in 2003.



## **Selection**

Simply select only the best situations. If you are in doubt about whether a stock is a good situation or not, the stock is NOT a good situation.

If you have to do a lot of work to determine whether the stock is a good situation, the stock is NOT a good situation.

If you can't sleep at night because you are too excited about the stock's value, and the more you look at the company, the more value you discover, the stock is a good situation.

Only trade good situations.



*How to Find a Home Run Stock by John Lux*

## **Missing Stocks**

You must remember that there is no cost to you for missing a good situation. Only buying into a bad situation will cause a loss. When in doubt, don't buy.



## **How to Buy (and Sell)**

There are several rules when buying a stock.

First, if you can, do not buy until the stock starts to move up. The reason I say, if you can, is because this piece of advice almost amounts to the advice given by Mark Twain, something to the effect that you should buy only the stocks that are going up, and when they go up, sell them. The point is that the only way to be sure that a stock is going up is to watch it go up. If it does go up, then it is too late to buy. However, a careful watch of technical patterns may give signals that you can act upon in a timely manner. Then again, the stock may jump 50% in a day.

Buy when the stock is going your way. Get out if it reverses direction or breaks a trend line. Do not stop to ask why this change has happened. **JUST GET OUT NOW.**

My classic example was Braintech. The stock ran from \$5 to \$24 ½ in only three months. Braintech then traded between \$20 and \$24 for two months. Everyone in the stock was expecting the company to announce large orders, boosting the stock higher. One day the stock fell to \$18 for no reason. That was enough to tell me to get out. In other words, there was no news yet the stock was down. Beware of stocks that decline for no reason. There is a reason, but the reason is unknown to you. By the time you find out, it will be too late to sell at a good price. Do not stop to ponder, just get out immediately.



*How to Find a Home Run Stock by John Lux*

Second, don't chase price. The following chart shows why you should not chase price. A mere two point increase in price may reduce your return by 33%.

Assume the stock goes to \$20 in one year:

<b>If you buy at:</b>	<b>% return</b>	<b>% decline in your return</b>
\$10	100	0%
\$11	82	8%
\$12	67	33%
\$13	54	46%
\$14	43	57%
\$15	33	66%

So by paying 30% more, you cut your return by over half.



*How to Find a Home Run Stock by John Lux*

Third, keep your powder dry. In other words, stay in cash until you are sure you are sure. Do not jump in and trade just to have something to watch in the paper. Cash is the one irreplaceable asset. Cash converts into anything, and people desperate for cash will give you the bargains you want if you just wait.

And besides, being in cash is easier on the nerves.



*How to Find a Home Run Stock by John Lux*

## **When and how do you sell short?**



## **Short Selling**

Selecting shorts is the mirror image of buying. The ideal short has no cash and is losing money rapidly. It has negative working capital. It has a P/E over 30, it is over four times book value, and the RMV is less than  $\frac{1}{2}$ .

There is one exception to the concept that selecting short sales is the mirror image of finding longs. In buying a stock, the most you can lose is all you invested. On every long stock, there is substantial support for the stock at \$0 on the chart. There is a big market from the people who buy waste paper at \$1 per 100 pounds for those stock certificates. So your losses are limited. Not so with shorts.

Those who were smart enough to see that Home Shopping Network would sell eventually at \$5 and short it at \$20 were rather dismayed when the stock sold at \$47, no doubt.

Selling short too early and hanging on has all the benefits of standing on the railroad tracks in front of a speeding locomotive.

Therefore, all but the richest investors had better not take more than the most easily coverable short positions. Short positions are rated in the number of days of average volume it would take to cover the position. Under no circumstances should an individual investor ever go short more than one day's average volume.

There are those who specialize in finding short sellers with large positions and then buying up the stock, forcing the shorts to buy back the stock from them. This results in large losses for the shorts and large, yet risky, profits for the longs.



*How to Find a Home Run Stock by John Lux*

Wells Fargo is such a stock. The shorts felt that the bank had taken on much too many risky or bad loans. They were short in late 1990 when the stock was as low as \$41 ¼. The stock subsequently was bid up to \$98. At the same time, note that earnings did fall about 50%.

Small comfort for the shorts who shorted the stock at unfavorable prices relative to book values and P/E ratio in 1990, before the up move.

McDonnell Douglas (MD) is another famous economic short sale/short squeeze. The stock went from \$26 to \$80 in 1991.

Successful short selling is built on finding an overvalued stock and the judgment to call the peak. Selling too soon can kill you.



## **Review**

Before we go on, let us review the rules:

1. Present value is more valuable than future value.
2. Price is everything.
3. A stock is a value if you can't buy it any cheaper than the price it is now.
4. Look for the maximum disparity between price and value.
5. Value is determined by assets and earnings. Assets are more important than earnings.
6. Use these ratios: RMV, P/E, Cash and working capital per share, book value.
7. Use leverage if possible.
8. Growth is due to a franchise.
9. Search all possible stocks.
10. Make simple trend lines.
11. Look for insider activity, including company repurchases.
12. Don't chase a stock.
13. Hold cash.
14. Be careful of shorts.
15. Stay away from things you do not understand.



*How to Find a Home Run Stock by John Lux*

## **Other**

Further Reading

Rules Summary

Feedback

Future Material

About the Author Index



*How to Find a Home Run Stock by John Lux*

### **Further Reading**

Technical Analysis, MacGee and Edwards

The Meaningful Interpretation of Financial Statements, Donald E. Miller

Unaccountable Accounting, Abraham K. Briloff

More Debits Than Credits, Abraham K. Briloff

Reminiscences of a Stock Operator, Edwin Lefevre

The Midas Touch, John Train

Security Analysis, Graham and Dodd



## **Summary of the Rules**

1. Present value is more valuable than future value.
2. Price is everything.
3. A stock is a value if you can't buy it any cheaper than the price it is now.
4. Look for the maximum disparity between price and value.
5. Value is determined by assets and earnings. Assets are more important than earnings.
6. Use these ratios: RMV, P/E, Cash and working capital per share, book value.
7. Use leverage if possible.
8. Growth is due to a franchise.
9. Search all possible stocks.
10. Make simple trend lines.
11. Look for insider activity, including company repurchases.
12. Don't chase a stock.
13. Hold cash.
14. Be careful of shorts.
15. Stay away from things you do not understand.



*How to Find a Home Run Stock by John Lux*

## **Feedback**

I would love to hear from you and share your wins. I also want your feedback for improvement. When you are done reading, let me know:

What are your suggestions for additions to the next edition?

What should be deleted from the next edition?

What would you like to contribute to the next edition?

Send feedback to me personally:

By e-mail: [john@asklux.com](mailto:john@asklux.com)

By mail:

John Lux

PO Box 3490

St. Petersburg, FL 33731



*How to Find a Home Run Stock by John Lux*

I would like you to vote on what future information you would like to have. You can check some or all of the items given, or add some of your own. I will keep you posted if you give me your name and e-mail address.

Be sure to tell me what you would like to know more about. For example, new issues, bankrupt companies, preferred stocks, options, security analysis, financial accounting, technical analysis, predicting the market, money and the stock market, low-priced stocks, venture capital, angel investing.

<mailto:john@asklux.com>

---

Thank you for helping me assist you.



*How to Find a Home Run Stock by John Lux*

### **About Your Author**

I, John E. Lux, am a former OTC stock trader. You can go to [www.asklux.com](http://www.asklux.com) for more about me.





## *How to Find a Home Run Stock by John Lux*

Home Run Stock		Multex.com	79, 81, 167, 168
defined	16		
Home Shopping Network	36, 152		
Hoover's Online - Home Page	81, 167	<b>N</b>	
How to Buy (and Sell)	148	NASDAQ	73, 79
How to Chart Stocks	142	NASDAQ stocks	73
How to Determine Value	47	National Stock Summary	17, 79, 83
		net value of the assets	41
<b>I</b>		new money	116
Imreg	16	New York Stock Exchange	79, 125, 137
information about a stock	120	Nifty 50" institutional stocks	19
information to shareholders	82	Nightly Business Report	116
insiders	82, 84, 112, 113, 117, 118		
Intangibles	55	<b>O</b>	
Interpreting Insider Trading	84	operating leverage	63
Inventory	55	options	63, 67, 159
investment bankers	113	OTC Bulletin Board	79
<b>J</b>		<b>P</b>	
John Lux	128, 158	P/E	43, 44, 64, 65, 66, 71, 72, 74, 76, 91, 92, 93, 94, 122, 144, 152, 153, 154, 157
		pattern of stock prices	139
<b>K</b>		PCQuote.com - Insider Trading	83, 167
keep your powder dry	150	Pendulum theory	36, 37
		pink sheets	73, 79, 83
<b>L</b>		Pink Sheets	79
Large cap	73	preferred	60, 61, 67, 159
Large Companies	10, 144	Present v. Future Value	24
let us review the rules	154	Price	27, 98
Leverage	9, 63	price and value	35
Lipe Rollway	77	price deflation	64
listed stocks	73	price goes against you	103
Lycos	79, 83, 168	price going down	98
		price going sideways	100
<b>M</b>		price going up	99
MacGee and Edwards	156, 167	price in motion	101
Making the Search	77	price is everything	27
Manufactured Homes	16, 30, 76	price that has changed motion	102
margin	63, 94, 137	Price the company buys its own stock at	66
Marginable stocks	73	price to book value	44
Market value to revenue ratio	66, 74	Property, Plant and Equipment	55
marks up the price	118	Proprietary Position	86
McDonald's	90		
McDonnell Douglas	153	<b>Q</b>	
Memory Metals	16	Quicken Brokerage - Insider Trading	83, 167
Mergents	79	Quicken Brokerage Stock Search	81, 167
Merrill Lynch	121		
Mesa Air Group	48	<b>R</b>	
<b>Microsoft</b>	31, 94, 141	random walk	27
Missing Stocks	147	Range of ratios	74
<u>More Debits Than Credits</u> , Abraham K. Briloff	156,	Ratio to Use in Selecting a Stock	75
167		Ratios	9, 66
MSN Money - Insider Trading Stock Transactions	83,	Receivables	55
167		Red Hat	29, 37



*How to Find a Home Run Stock by John Lux*

Reminiscences of a Stock Operator, Edwin Lefevre 156, 167

reorganization 61

Revenue to Market Value ratio 64

revenues compared with the market value 64

ripple 116

risk 22

RMV 64, 66, 71, 72, 76, 77, 144, 152, 154, 157

rubber band 35

**S**

sales 16, 24, 62, 63, 64, 65, 66, 74, 77, 83, 142, 144, 152

savings and loans 73

Sawell, Inc. 144

SEC 79, 82, 83

Security Analysis, Graham and Dodd 156, 167

Selection 10, 146

selling, general and administrative expense 62

SG&A 62

shareholders equity 41, 52, 60, 62, 66, 67

short positions 152

short sellers 24

Short Selling 10, 152

short term debt 60

silver 33

Standard and Poors Corporate Records 79

State corporate law 82

stock is strong on bad news 103

Summary of the Rules 157

**T**

Technical Analysis 98, 156, 167

technical analysts 34

Texas Instruments 64

the Crash 128

The Earnings Statement 62

The Fallacy of Growth 93

The Meaningful Interpretation of Financial Statements, Donald E. Miller 156, 167

The Midas Touch, John Train 156, 167

The One Most Important Concept 35

The trend is your friend 100, 101

*The Wall Street Journal* 64, 65

Thomson - Insider Trading Center 83, 168

Time-Warner 140

tip 120

top down 24

treasury stock 56, 66, 67

two most important concepts 35

**U**

Unaccountable Accounting, Abraham K. Briloff 156, 167

underpriced stock 142

utilities 73

**V**

Value 29

Value Line 79, 144

Vickers 83, 168

**W**

warrant 60, 61, 63

Wells Fargo 153

what is more important, earnings or assets? 41

What is Value? 33

When to Sell 109

Wolverine Worldwide 52, 56, 67

Working capital per share 66, 72, 74, 76

Wright's Company Profiles 81, 167

www.10kwizard.com 79, 168

www.Corporateinformation.com 81, 167

www.freedgar.com 79, 168

www.stockworm.com 81, 167

**Y**

Yahoo! Finance Company and Fund Index 81, 167

Yahoo.com 81, 167



## **History**

I thought that you might be interested in how this book came to be.

I grew up interested in science and solving problems until I went to college and they taught me that I was not going to be an engineer.

I switched to education, until they taught me that it was not for me.

I was at a loss until my father told me "If you are going to sponge off me, kid, you are going to work. Plot my commodity charts."

So I did. He gave me months of back prices and I began the boring job of plotting them day by day on graph paper.

To ease the tedium, I started guessing which way the prices would move. I was right almost always!

So he gave me a pile of books on trading and I began my education. I got a job as a clerk at E. F. Hutton & Co on Wall Street in their OTC department. I read everything I could get my hands on. I studied and traded for years and years. After 15 years, I put it all together, I tested it day after day, and finally, you have this book.



## **Rate Yourself**

There is an old Wall Street joke about the investor who is taken to the top of a tall building at the end of Manhattan. As he looks down into the harbor, he is shown the enormous yachts belonging to the large brokerage firms, (I won't give you the names). After he is shown all of the expensive boats sitting in the harbor and they are all identified as belonging to various brokers, he asks the famous question, "Where are all the customers' yachts?"

We are now going to find out where your yacht is. Results tell the tale. Ask yourself the following questions:

1. Do I listen to tips and rumors?
2. Do I listen to the opinion of others?
3. Do I look for stocks and use my own judgment or do I let self-interested people recommend stocks to me?
4. When I fill out my income tax form at the end of the year, what is the bottom line? How many gains and how many losses?
5. How much time am I willing to put into investing? If you are able to put little time into it, do you have someone to do it for you who has your best interest at heart?
6. Do you chase stocks on the move?
7. Do you trade on the basis of news, or on fundamentals?



## **Links**

### **Books**

Technical Analysis, MacGee and Edwards

The Meaningful Interpretation of Financial Statements, Donald E. Miller

Unaccountable Accounting, Abraham K. Briloff

More Debits Than Credits, Abraham K. Briloff

Reminiscences of a Stock Operator, Edwin Lefevre

The Midas Touch, John Train

Security Analysis, Graham and Dodd

### **Websites**

Multex.com

Yahoo.com

Quicken Brokerage Stock Search

www.stockworm.com

Quicken Brokerage Stock Search

<http://s1.simplystocks.com/>

<http://www.stockfetcher.com/>

www.wallstreetmentors.net

Hoover's Online: StockScreener

Hoover's Online - Home Page

Wright's Company Profiles

Yahoo! Finance Company and Fund Index

www.Corporateinformation.com

MSN Money - Insider Trading Stock Transactions

Quicken Brokerage - Insider Trading

PCQuote.com - Insider Trading



*How to Find a Home Run Stock by John Lux*

Lycos Finance - Insider Trading

Vickers Stock Research

Thomson - Insider Trading Center

Yahoo's Investment Services

Multex.com

<http://www.sec.gov/edgar.shtml>

[www.10kwizard.com](http://www.10kwizard.com)

[www.freedgar.com](http://www.freedgar.com)

[www.otcbb.com](http://www.otcbb.com)

[www.pinksheets.com](http://www.pinksheets.com).