Audio-Tech Business Book Summaries

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- ***Learn...*** the seven step CAN SLIM™ system for finding winning stocks, based on a study of the most profitable stocks for each year dating back to 1953.
- ***Enhance...*** your wealth by avoiding the 19 mistakes that keep most investors from enjoying better returns.
- ***Understand...*** how you can use key measures such as a stock's earnings per share to pick stocks that are ready to soar.
- ***Discover...*** the truth behind price-earnings ratios, and why it can sometimes be wiser to buy stocks with high P/E ratios instead of those with low ones.
- ***Realize...*** that you can make big profits by buying a stock when it is selling at a new high, instead of buying stock that has hit a new low.

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How to Make Money in Stocks

A Winning System in Good Times or Bad

Third Edition

***by* William J. O'Neil**

A summary of the original text.

We live in a fantastic time of unlimited opportunity, an era of outstanding new ideas, emerging industries, and new frontiers. Brilliant technologies, new software, advances in genetic engineering, and innovative business models all create new opportunities to make wealth in the stock market.

But to find the *right* stocks — the ones that will make money — you have to follow a proven, disciplined system for success in both good and bad markets.

Many people who invest in the stock market either achieve mediocre results or lose money because they lack knowledge. But there's no excuse for poor performance. With the rules you will learn in this summary, you can definitely learn how to pick big winners in the stock market and become part owner of the best companies in the world.

All you need to remember is a proven, simple, fact-based system called CAN SLIM™. The system consists of rules for buying and selling stocks that is derived from an extensive analysis of all of the greatest winning stocks each year for the last half-century.

Each letter in the words CAN SLIM stands for one of the seven chief characteristics of these greatest winning stocks at their early stages, just before they made huge profits for their shareholders.

We'll soon explore each of these characteristics in detail, but let's get started right now with a preview of CAN SLIM:

- ***C*** is the first letter in *Current Quarterly Earnings per Share:* The higher, the better.
- ***A*** stands for *Annual Earnings Increases:* Look for significant growth.

- ***N*** is short for *New Products, New Management, New Highs:* Buy at the right time.

- ***S*** refers to *Supply and Demand:* Look for shares outstanding, plus big volume demand.

- ***L*** refers to *Leader or Laggard:* Determine which category your stock is in.

- ***I*** is short for *Institutional Sponsorship:* Follow the leaders.

- ***M*** represents *Market Direction:* You need to be able to determine it.

The reason that CAN SLIM continues to work, cycle after cycle, is because it is based solely on the reality of how the stock market actually works, rather than personal opinions, including those of the experts on Wall Street. Further, human nature at work in the market simply doesn't change. So CAN SLIM does not get outmoded as fads, fashions, and economic cycles come and go.

How have these disciplined buy-and-sell rules performed in good and bad markets? The American Association of Individual Investors compared the CAN SLIM system to other well-known methods of selecting stocks, such as those of Peter Lynch, Warren Buffett, and many others. The comparison included the bull market years of 1998 and 1999, as well as the bear market of 2000. Their independent study, published in 2001, found that CAN SLIM had the best and most consistent performance record each year. The results were a 28.2 percent return for 1998, 36.6 percent for 1999, and an astonishing 30.2 percent during the disastrous market of 2000 that ruined the portfolios of many other investors.

Now, let's explore how you can put the CAN SLIM system to work in enriching your own portfolio.

C = CURRENT QUARTERLY EARNINGS PER SHARE

Let's start with the *C* in CAN SLIM: Current Quarterly Earnings per Share.

If you look down the list of the market's biggest winners over the past 50 years, you'll instantly see the relationship between booming profits and booming stocks. Consider these recent examples:

- Cisco Systems posted earnings-per-share, or EPS, gains of 150 percent and 155 percent in the two quarters ending October 1990, prior to its 1,467 percent price run-up over the next three years.

- Accustaff showed a 300 percent profit increase just before its price gain of 1,486 percent in the 16 months from January 1995.

- Ascend Communications saw earnings up 1,500 percent in August 1994, just prior to its 1,380 percent price move over the next 15 months.

In fact, of all the characteristics that O'Neil studied, none stood out as boldly as the profits each big winner reported in the latest quarter or two before its major price advance. In his models of the 600 best-performing stocks from 1952 to 2001, three out of four showed earnings increases averaging more than 70 percent in the quarter before they began their major advances. The remaining 25 percent did so the very next quarter and had an average earnings increase of 90 percent.

Here is the rule to remember: *The stocks you select should show a major percentage increase in the most recently reported quarterly earnings per share, relative to the prior year's same quarter.*

The EPS number is calculated by dividing a company's total after-tax profits by the number of common shares outstanding. This percentage change in EPS is the single most important element in stock selection today. The bigger the increase, the better. There is absolutely no reason for a stock to go anywhere good if earnings are poor.

Following the CAN SLIM strategy's emphasis on earnings ensures that an investor will always be led to the strongest stocks in any market cycle, regardless of any temporary, highly speculative "bubbles" or euphoria. But remember, don't buy on earnings growth alone. We'll cover the other key factors later in this summary.

It's important to watch out for misleading earnings reports. A company may report record sales of $7.2 million versus $6 million, for an increase of 20 percent for the quarter just ended. The company also had record earnings of $2.10 per share, up 5 percent from $2.00 per share for the same quarter a year ago. Consider: Why are sales up 20 percent but earnings up only 5 percent. What happened to the company's profit margins — and why?

The key question for the winning investor must always be:

How much are the current quarter's earnings per share up, in percentage terms, from the same quarter the year before?

Furthermore, always compare earnings for the same period year-to-year, not sequential quarters, which can cause distortion. In other words, don't compare the earnings from the December quarter to those from the September quarter. Rather, compare the December quarter from this year to the December quarter of last year for a more accurate evaluation. Also, avoid the trap of being influenced by nonrecurring profits. Ignore the earnings that result from extraordinary, one-time gains, such as the sale of real estate.

Whether you're a new or experienced investor, avoid buying any stock that does not show EPS up at least 18 to 20 percent in the most recent quarter versus the same quarter the year before. To be even safer, insist that both of the last two quarters show significant earnings gains.

Keep in mind that strong, improved quarterly earnings should always be supported by growth in sales. Look for growth of at least 25 percent for the latest quarter, or at least acceleration in the rate of sales percentage improvement over the last three quarters.

Some professional investors bought Waste Management at $50 in early 1998 because earnings had jumped three quarters in a row, from 24 percent to 75 percent to 268 percent. This seemed a clear signal to buy the stock, until one considered the company's sales, which increased only by 5 percent. Several months later, the stock collapsed to $15 a share.

What this demonstrates is that earnings can be inflated for a few quarters by cutting costs in such areas as advertising or R&D. To be sustainable, earnings growth must be supported by increases in sales. Such was not the case with Waste Management.

You now know the first critical rule for selecting winning stocks: Current earnings per share should be up significantly — at least 25 percent or more — over the same period for the previous year. The best companies might show earnings increases of 100 percent to 500 percent or more. A mediocre 10 or 12 percent is not enough. When picking winning stocks, it's the bottom line that counts.

A = Annual Earnings Increases

Any company can report a good earnings quarter every once in a while. As we've discussed, strong current quarterly earnings are critical to picking most of the market's big winners. But it is not enough.

To ensure that current earnings aren't just a flash in the plan, you must insist on more proof. The way to do that is by reviewing the company's annual earnings growth rate, which is represented by the letter *A* in CAN SLIM.

Look for annual earnings per share that have increased every year for the past three years. You normally don't want the second year's earnings down, even if the following year rebounds and is in new high ground. It is the combination of strong earnings in the last few quarters, plus a record of solid growth in recent years, that creates a superb stock.

To find winning stocks, select companies with annual earnings growth rates of 25 percent, 50 percent, or even 100 percent or more.

Between 1980 and 2000, the median annual growth rate of all outstanding stocks in the study was 36 percent at their early emerging stage. A typical EPS progression for the five years preceding the stock's major move might be something like $0.70, $1.15, $1.85, $2.65, and then $4.00.

It might be acceptable to have one down year if the following year's earnings quickly recover and move back to new high ground. However, a move from $4.00 to $5.00, to $6.00, then to $2.00 and $2.50 would *not* be acceptable. Even though the fifth year produced a significant increase over the fourth year, that increase is still considerably below previous years.

Also, you should not ignore a company's annual return on equity. The greatest winning stocks of the past 50 years had ROEs of at least 17 percent. Return on equity helps separate the well-managed firms from the poorly managed ones. Additionally, look for growth stocks that show annual cash flow per share greater than actual EPS by at least 20 percent.

The stability of earnings is also important. Check the pattern for at least three years. The stability measurement that O'Neil developed uses a scale of 1 to 99. The lower the number, the more stable the past earnings record.

The figures are calculated by plotting quarterly earnings for the past five years, and fitting a trend line around the plot points to determine the degree of deviation from the basic trend.

Growth stocks with steady earnings tend to show a stability figure below 20 to 25. Companies with stability numbers over 30 are more cyclical and a little less dependable in terms of growth. These figures are usually shown immediately after the company's annual growth rate on most investment services.

If you restrict your stock selections to companies with proven growth records, you will avoid the hundreds of investments with erratic histories.

Emphasizing three-year annual EPS criteria will help you to weed out 80 percent of the stocks in any industry group. Earnings per share should be excellent for both current periods and for a three-year period to warrant serious consideration as an investment.

The fastest way to find a company with strong and accelerating current earnings and three-year growth is by checking the EPS rating provided for every stock listed in *Investor's Business Daily.* The EPS Rating is defined as a measure of a company's two most recent quarters' earnings growth rate, compared to the same quarters one year prior. Then, the company's three-year annual growth rate is examined.

The results are compared to all other publicly traded companies and rated on a scale of 1 to 99, with 99 being best. An EPS Rating of 99 means a company has outperformed 99 percent of all other companies in terms of both annual and recent quarterly earnings performance.

But what about price-earnings ratios? Are they really important? Prepare yourself for a big surprise.

P/E ratios have been used for years by analysts as their basic measuring tool to decide if a stock is undervalued and should be bought, or overvalued and should be sold. However, O'Neil's analysis of the most successful stocks from 1952 to the present shows that P/E ratios were *not* a relevant factor in price movement and have very little to do with whether a stock should be bought or sold.

P/Es are an end effect, not a cause. To say a stock is "undervalued" because it is selling at a low P/E is nonsense. It is much more crucial to look at whether the rate of change in earnings is substantially increasing or decreasing.

From 1953 to 1985, the average P/E ratio for the best-performing stocks at their early emerging stage was 20. At the time, the average P/E of the Dow Jones Industrial Average was 15. While advancing, the biggest winners expanded their P/Es by 125 percent to about 45. During the 1990-95 period, the real leaders began with an average P/E of 36 and expanded into the 80s. Since these are averages, the beginning P/E range for most big winners was 25 to 50, and the P/E expansions varied from 60 to 115. The late 1990s market euphoria saw these valuations increase to even greater levels. Value buyers missed all of these tremendous investments.

If you were not willing to pay an average of 25 to 50 times earnings, or even much more, for growth stocks, you automatically eliminated many of the best investments available. You would have missed out on Microsoft, Cisco Systems, Home Depot, and America Online during their periods of greatest market performance.

The lesson is this: In a roaring bull market, don't overlook a stock just because its P/E seems too high. It could be the next great stock market winner.

Another faulty use of P/E ratios is to evaluate stocks in an industry and conclude that one selling at the cheapest P/E is undervalued and therefore the most attractive one to buy. The reality is that the lowest P/E usually belongs to the company with the most ghastly earnings record, and that's precisely why it sells at the lowest P/E.

The simple truth is that stocks generally sell near their current value, based on economic conditions, earnings, events, and psychology, which are reflected in the P/E ratio. A stock that sells for 7 times earnings does so because its overall record is more deficient than one with a higher P/E ratio.

In situations where small growth companies have revolutionary new products, what seems like a high P/E ratio can actually be low. Consider:

- Xerox sold for 100 times earnings in 1960 — before it advanced 3,300 percent in price.
- Syntex sold for 45 times earnings in July 1963 — before it advanced 400 percent.
- Genentech was priced at 200 times earnings in November 1985, and it increased 300 percent in five months.
- America Online sold for over 100 times earnings in November 1994 before increasing 14,900 percent from 1994 to its top in December 1999.

These companies had fantastic new products: the first dry copier, the oral contraceptive pill, the use of genetic information to develop new wonder drugs, and access to the revolutionary new world of the Internet. If you had a bias against P/Es you considered too high, you would have missed out on the tremendous price advances these stocks made.

In other words: Don't sell high P/E stocks short. Follow the second critical rule: *Concentrate on stocks with proven records of significant earnings growth in each of the past three years, plus strong recent quarterly improvements.* Don't accept anything less.

N = New Products, New Management, New Highs

How do dramatic advances in a stock's price occur? Inevitably it's the result of something new to the existing business. This is the *N* in CAN SLIM: new products, new management, and new highs.

In the study of the greatest stock market winners from 1952 through 2001, more than 95 percent of stunning successes met at least one of these three criteria. It can be remarkable new products or services that cause a surge in sales and profits. It can be new management that brings new vigor and new ideas and a new beginning to the organization. Or new conditions, such as shortages, price increases, or revolutionary technologies, can affect most stocks in an industry group in a positive way.

The number of new products that have made a dramatic impact on companies' earnings is almost too numerous to mention, but here are just a few:

- Rexall's new Tupperware division in 1958 pushed the company's stock from $16 to $50 per share.
- McDonald's, with its new approach to low-priced, fast food franchising,

exploded 1,100 percent from 1967 to 1971.

- Amgen developed two successful biotech drugs in 1991 and 1992 and the stock went from $60 in 1990 to the equivalent of $460 in 1992.

- Dell Computer, the leader in built-to-order direct mail computer sales, advanced 1,780 percent from November 1996 to January 1999.

The issue for all of these stocks was picking the timing of that breakout price advance. As mentioned previously, be suspicious of short-term spikes in earnings. They can be the result of "cost savings" that harm long-term innovation.

O'Neil explains another characteristic found in the early stages of all winning stocks: the "great paradox." Many buyers are more comfortable to "buy low and sell high." Among the hundreds of thousands of investors who attended his investment lectures over the past three decades, 98 percent say they do not buy stocks that are reaching new highs in price. Most institutional investors are also "bottom buyers" that prefer to buy stocks that are selling near their lows.

The study of the greatest stock market winners proved that the "buy low, sell high" strategy is completely wrong. In fact, the analysis proved the exact opposite: *What seems too high in price and risky to the majority usually goes higher, and what seems low and cheap usually goes lower.*

A second study yielded the same conclusion. O'Neil analyzed two groups of stocks over many market periods: those that made new highs, and those that made new lows. The results were conclusive: Stocks on the new-high list tended to go higher in price, while those on the new-low list tended to go lower.

Rather than buy such low-priced "bargains," an investor usually would be smart to avoid them. A stock making the new-high list might offer great returns, especially if it is trading on big volume during a bull market.

The trick is being able to identify those stocks that, despite reaching a new high, are ready to really break out of past patterns. For example, in 1990 the investor who bought Cisco Systems at its "scary" new high, the highest price in its history, enjoyed a nearly 75,000 percent increase from that point forward.

The issue is timing. The perfect time to buy is during a bull market just as the stock is starting to break out of its price base. This is the "pivot" or buy point.

In conclusion: *Look for companies that have developed important new products or services, or have benefited from new management, or new industry conditions. Then buy their stocks when they are emerging from price consolidation patterns and are close to, or actually making, new highs.*

S = SUPPLY AND DEMAND

Now let's move on to the *S* in CAN SLIM: Supply and Demand, or shares outstanding plus big volume demand.

The law of supply and demand determines the price of almost everything in life, including stocks. The price of a common stock with 5 billion shares outstanding is harder to budge because there's a large supply. It takes a large volume of buying, or demand, to create a significant price increase.

On the other hand, if a company only has 50 million shares outstanding, just a small amount of buying, or demand, can push the price up more rapidly. This means that if you are choosing between two stocks to buy, the one with the fewer shares will usually be the better performer, if other factors are equal.

However, since smaller-cap stocks are less liquid, they can come down as fast as they go up — sometimes even faster. In other words, with greater opportunity comes greater risk.

In general, large-cap companies offer some advantages: greater liquidity, less downside volatility, better quality, and usually less risk. The immense buying power of large funds can make a big stock advance as fast as shares of a smaller firm.

However, large companies can also suffer from a lack of imagination. They are typically less willing to innovate, take risks, and keep up with the times. Most new products come from young, hungry, innovative, small- and medium-sized companies with entrepreneurial management. Not coincidentally, these businesses, often in the service and technology industries, tend to grow much faster and create most of the new jobs.

There are two other signs to look for regarding supply:

- First, look for companies that are buying back their own stock. In most, though not all cases, this is a good sign. This means that there will be fewer shares outstanding and that earnings per share — one of the principal driving forces behind outstanding stocks — will be higher.
- Second, low corporate debt-to-equity ratio is generally better. Such companies are not vulnerable to interest rate spikes that can harm earnings.

Any type of stock, from small-cap to large-cap, can be bought under the CAN SLIM method. However, small cap stocks will be more attractive as break-out investments. Just be aware that they are substantially more volatile, both on the upside and downside. From time to time, the market will shift its emphasis from small to large caps, and vice versa.

L = Leader or Laggard?

People tend to buy stocks they like, or stocks that make them feel comfortable. But in a bullish stock market, these sentimental picks often lag the market rather than lead it. This brings us to the *L* in CAN SLIM — determining whether the stock is a leader or a laggard.

Suppose you buy a stock in the computer industry. If you buy the leader in the group, and your timing is right, you have a chance at real price appreciation.

But if you buy a stock that is at the bottom of the pile, because you think you are getting a bargain, you might have bought a stock with little upward price potential. Why else would it be so far behind the pack?

The two or three leaders in an industry group can have unbelievable growth while the rest of the industry languishes. Home Depot advanced 10 times from 1988 to 1992, while Waban and Hechinger, the group's laggards, dramatically underperformed.

Buy the leaders, not the laggards. All of the big winners were the No. 1 companies in their industries at the time they were purchased. These companies included Syntex in 1963, Price Company from 1982 to 1985, Genentech from 1986 to 1987, and Charles Schwab from 1998 and 1999.

The market leader isn't necessarily the biggest company or the one with the most recognized brand name. It's the one with the best quarterly and annual earnings growth, return on equity, profit margins, sales growth, and price action. It also offers a superior product or service, and is gaining market share from its older, less innovative competitors.

O'Neil's research clearly shows that you should avoid "sympathy" stocks. A sympathy stock is a stock in the same group as a leading company and is bought in the hope that the leader's luster will rub off "in sympathy." These companies tend to produce copycat products, but don't deliver on the results. People buy these stocks because they are cheaper, but the lower price usually is lower for a good reason — it reflects the earning power of the company and, thus, its stock.

There's a fast and easy way to tell if a stock is a leader or a laggard: Use the Relative Price Strength Rating, or RS Rating. The RS rating is defined as:

A proprietary rating that measures the price performance of a given stock against the rest of the market for the past 52 weeks. Each stock is assigned a performance rating from 1 to 99, with 99 being the best. An RS rating of 99 means that the stock has outperformed 99 percent of all other companies in terms of price performance.

If a stock's RS rating is under 70, it is lagging the better-performing stocks in the market. That doesn't mean it can't increase in price, just that it probably will go up less.

The average RS rating of the best-performing stocks each year from the early 1950s through 2000 was 87 before their major run-ups. So the rule for winners is: *Avoid laggard stocks and sympathy moves, even if they look tantalizingly cheap. Focus on the market leaders!*

The RS Rating for all NYSE, NASDAQ, and Amex stocks is listed each day in *Investor's Business Daily.* Updated RS Ratings are also found on the *Daily Graphs Online* charting service.

To upgrade your stocks and concentrate on the leaders, restrict your purchases to companies that have an RS Rating of 80 or higher. Many of the big money-making selections have RS ratings of 90 or higher before breaking out to higher price appreciation.

You can find new leaders in a market downturn by watching the decline percentages. The more desirable growth stocks correct 1 1/2 to 2 1/2 times the general market average. In a bull market, growth stocks declining the least are generally the best selections. The higher the decline, the less desirable.

Once a general market decline is over, the first stocks that bounce back to new price highs are almost always the true leaders.

I = Institutional Sponsorship

Now we're ready to discuss the *I* in CAN SLIM: Institutional Sponsorship. This refers to the shares of stock owned by investment groups, such as mutual funds, pension funds, banks, and so on.

It takes big demand to move prices up, and by far the largest source of big demand are the institutional investors who account for the greatest share of each day's market activity.

A winning stock doesn't need to have a huge number of such investors, but it should have at least 10. If a stock has none, chances are likely that its performance will be run-of-the-mill.

The next important assessment is the *quality* of the institutional owners: How many, if any, of the best portfolio managers own the stock? Look for stocks held by at least one or two of the more savvy portfolio managers who have the best performance records. You can consult a fund's 36-Month Performance Rating in *Investor's Business Daily;* an A+ rating indicates a fund is in the top 5 percent of all funds for performance. Many other financial services also publish performance records of various institutions.

In general, buy companies that show an increasing number of institutional owners over several recent quarters. A metric in *Investor's Business Daily*, called the Sponsorship Rating, ranges from A, for best, to F, for worst. Stocks with an A rating indicate increased buying by the better money managers in the market.

It is, of course, possible to have *too much* institutional sponsorship. Stocks can be "overowned" by institutions and such excessive ownership can translate into large-scale selling if something goes wrong with a stock. The result can be not just a correction, but a calamity if one institution sells, say, 500 million shares of a company in one transaction.

The rule for wise investors is to *only buy stocks that have at least a few institutional sponsors with better-than-average recent performance records, and invest in stocks showing an increasing total number of institutional owners in recent quarters.*

M = Market Direction

Finally, the last characteristic of the greatest winning stocks is market direction, the *M* in CAN SLIM.

You can be right about each of the six previous factors, but if you're wrong about the direction of the general market, three out of four of your stocks will plummet with the market averages, and you will certainly lose big money as many people did in 2000. Therefore, you absolutely must have a reliable method to determine if you're in a bull or bear market.

The best way to determine the direction is to follow, interpret, and understand what the general market averages are doing every day. The general market refers to the most commonly used market indices: the Dow Jones Industrial Average, the S&P 500, and the NASDAQ Composite.

Watch recent market cycles to get a sense of length and character of the current market. Examine the general market trends daily to spot reverses that signal a change in direction. Typically, in bear markets, stocks open strong and close weak. In bull markets, they open weak and close strong. It is important to sell when the general market tops. This will protect your gains and give you liquidity to buy later.

Don't be seduced by the myth of long-term investing. The idea of buying and holding through thick and thin intuitively appeals to most people's sense of stability. If the price of a good company goes down during a general bear market, it will come back when the next bull market takes over. Right? Yes, but stocks don't lose value at the same rate and they don't recover at the same pace or to the same degree.

If you use stop orders, you will automatically be forced out of many of your stocks in a market that is beginning to top out. It's usually better not to use stop-loss orders because you are tipping your hand to market makers. At times, they might drop the stock to shake out stop-loss orders. Instead, if possible, follow your stocks closely and know the exact price at which you will immediately sell to cut a loss. If you are too busy to watch your stocks closely, stop-loss orders can protect you against big losses.

You can detect a market top by watching the major indices as they work their way higher. On one of the days in the uptrend, volume will increase from the day before, but the averages will close either flat or down, and certainly with less increase than the previous day. If the average does in fact close down, it will be easier to spot the selling by professional investors as they liquidate their positions. The spread from the day's high to its low might be a little wider than on previous days.

Normal liquidation near the market peak will usually occur on three to five days over one, two, or three weeks. In other words, the selling occurs *while the market is still advancing.*

After four or five days of definite selling, the general market will almost always turn down. Sometimes this can occur over six to seven weeks. If you cut your losses and sell at 7 to 8 percent below your buy points, you always will be forced to sell at least some stocks as a correction in the general market begins to develop. Equally important, this approach gets you into a defensive, questioning frame of mind sooner. Following this simple rule saved a lot of people big money in the devastating decline in technology stocks during 2000.

Shifts in market direction can also be detected by reviewing the last four or five stock purchases in your own portfolio. If you haven't made a dime on any of them, you could be picking up on a trend.

Another sign of a top is the strengthening of low-priced, low-quality stocks. This is a signal that the upward market is near its end. A downturn eventually takes down all stocks, both the leaders and followers. If the leaders can't lead, it isn't reasonable to expect the laggards to handle the job. A topping market can even recover for a couple of months and get near or even above its old high before breaking down.

The next question to analyze is: How far is down? When can you spot a market bottom? A rally attempt begins when a major market average closes higher after a decline, either from earlier in the day or the previous session. On the fourth day of the attempted rally, look for one of the major averages to "follow through" with a 2 percent or more gain on heavier volume than the day before. The most powerful follow-throughs usually occur on the fourth to seventh days. The follow-through should be explosive, with a 2 percent or more gain on heavy volume.

A follow-through doesn't mean you should buy with wild abandon. It is a signal that it is OK to buy quality stocks, and it is a vital confirmation that the attempted rally is succeeding. No bull market ever started without a strong price and volume follow-through confirmation.

The time to capitalize on the opportunities is during the first two years of a normal bull market cycle. The rest of the up cycle usually consists of back-and-forth movement in the market averages followed by a bear market.

There are several additional ways to identify key market turning points:

1. *Look for divergence of key averages.* If they are moving in opposite directions, or in the same direction but at very different rates, it could be a turning point. If for example, the Dow advances significantly but the S&P 500, a much broader-based index, does not, it could mean a key turning point is at hand.

2. Study psychological indicators of the market's direction. The percentage of investment advisers who are bearish is an interesting measure of investor sentiment. In short, the majority is usually wrong. Similarly, the short-interest ratio, the amount of short interest selling on the New York Stock Exchange, can reflect the degree of bearishness shown by speculators.

3. *Watch Federal Reserve Board rate changes.* Among fundamental general market indicators, the Fed's discount rate and the Fed Funds rate are valuable indicators to watch. For example, three successive hikes in the discount rate have generally marked the beginning of bear markets.

4. Track other general market indicators, including:

   - The *upside-down volume* is a short-term index that relates trading volume in stocks that close up in price for the day to volume in stocks that close down.

   - The *percentage of new money flowing into corporate pension funds* gives an insight into institutional investor psychology.

   - An *index of "defensive" stocks* can provide insight into the market's direction; when these safer stocks start showing strength, it may be time to move into defensive positions.

The key point to remember is that you should learn to interpret the daily price and volume changes of the general market indices, and the action of the individual market leaders. Once you know how to do this, you will improve the performance of your investment portfolio.

NINETEEN COMMON MISTAKES MOST INVESTORS MAKE

If you follow the rules we've presented for putting the CAN SLIM system to work in your portfolio, you should enjoy excellent returns. However, even the most experienced investors often make the same classic mistakes that limit their profits or cause steep losses. Here are the 19 mistakes you must avoid:

1. ***Stubbornly holding on to losses when they are very small and reasonable.*** **Instead of getting out cheaply, many investors hold on until the loss gets so large it costs them dearly. Without exception, cut every loss at 7 to 8 percent.**

2. ***Buying on the way down in price, thereby ensuring miserable results.*** **A declining stock seems to be a real bargain. But remember: With few exceptions a stock's price is high or low for good reasons.**

3. ***Averaging down in***

price rather than up when buying. **If you buy a stock at $40 and then buy more at $30, and average your cost at $35, you are following your losers and putting good money after bad.**

4. ***Buying large amounts of low-priced stocks rather than smaller amounts of higher-priced stocks.*** **When you invest, buy the best merchandise available, not the cheapest. Low-priced stocks cost more in commissions and are more volatile, usually to the downside.**

5. ***Wanting to make a quick and easy buck.*** **Wanting too much, too fast, without the proper preparation, can lead to big losses.**

6. ***Buying on tips, rumors, split announcements, and other news events, stories, advisory service recommendations, or opinions you hear from supposed market experts on TV.*** **Trust what you have learned through hard work, not rumors and tips, which usually aren't true.**

7. ***Selecting second-rate stocks because of dividends or low price-earnings ratios.*** **Dividends and P/E ratios aren't as important as earnings per share growth. In many cases, the more a company pays in dividends, the weaker it may be.**

8. ***Never getting out of the starting gate properly due to poor selection criteria.*** **Many people buy highly speculative, risky stocks that have questionable earnings and sales growth; inevitably, they get what they deserve.**

9. ***Buying old names you are familiar with.*** **Many of the best investments will be newer companies that, with a little research, you could discover and profit from before they become household names.**

10. ***Not being able to recognize and follow good information and advice.*** **Friends and relatives can give bad advice. So can some stockbrokers and advisory services, because every profession includes a small minority who are top performers, many who are mediocre, and some who are truly awful.**

11. ***Being afraid to buy stocks that are going into new high ground in price.*** **A stock that reaches a new high may be on its way to much greater highs, as discussed earlier in this summary.**

12. ***Cashing in small easy-to-take profits, while holding the losers.*** **You should do the opposite: Cut your losses short, and let your profits grow.**

13. ***Worrying too much about taxes and commissions.*** **The money to be made by selecting the right stocks is enormous in comparison to the cost of taxes and commissions.**

14. ***Focusing on what to buy, and not understanding when the stock must be sold.*** **Timing your exit is as important as planning your entrance.**

15. ***Failing to understand the importance of buying quality companies with good institutional sponsorship.***

16. ***Speculating too heavily in options and futures because they're thought to be a way to get rich quick.***

17. ***Rarely transacting "at the market" and preferring to put price limits on buy and sell orders.*** **By quibbling on an eighth of a point, they miss the stock's larger and more important movement.**

18. ***Not being able to make up your mind when a decision needs to be made.*** **This invariably points to lack of a plan.**

19. ***Not looking at stocks objectively.*** **Relying on your emotions or only on your opinion is a recipe for failure.**

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When to Sell and Cut Your Losses

When does a loss become a loss? Many people feel that they only incur a loss when they actually sell at a loss and, thus, hold on — for even greater losses. In actuality, a loss occurs when the market price goes down. If 100 shares of a stock go from $40 to $28, the owner has only $2800 (instead of $4000)

of value, whether that is in cash or stock.

As mentioned elsewhere, limit your losses to 7 or 8 percent. The most important factor here is: If you use charts to time your buys at correct buy or "pivot" points coming off of *sound* chart bases, (price consolidation areas), your stocks will rarely drop 8 percent from a correct buy point. This is a big key for future success.

Once you are ahead and have a good profit, you can afford to give the stock more than the 7 or 8 percent limit. Do not sell a stock just because it is off its *peak* price. Being 7 or 8 percent off the *buy* point is a good deal different. It means that you picked the wrong stock and/or bought at the wrong time. You are losing your money. Being off the peak price means that you have earned a profit and can afford to give the stock a little more room. You can absorb a 10 or 15 percent correction. The key is timing your purchases exactly at breakout points in order to minimize the chance of your stock dropping 8 percent.

What if a stock gets away from you and loses 10 percent? Cut your losses immediately. Similarly, "buying on the dips" is an amateur' strategy that almost always leads to losses. And never invest on margin unless you're willing to cut all of your losses short. Small losses are like cheap insurance. Take your losses quickly and your profits slowly.

In a related vein: Never average down in price. It is one of the most unwise things an investor can do. A stock's price (down or up) is only important to the condition of the stock in the present. Thus, buying more of a stock whose price is falling is a sure recipe for disaster. Similarly, don't be too quick to take profits.

For longer-term investing, here is another method to use: At the end of each quarter, compute the percentage increase or decrease in price since the previous quarter and list them in order of their relative performance. After a few reviews, the winners and losers will become apparent. Then determine potential profit and possible loss. Identify these criteria and stick to them; e.g., 8 percent for losses and 125 percent for gains. However, don't fall into the trap of being the long-term investor who holds onto a stock no matter what happens. Cut your losses.

■■

When to Sell and Take Your Profit

If you don't sell early, you'll be late. The secret is getting off the elevator while it is still on its way up and avoiding the ride back down. And the key to doing so is having a profit and loss plan. O'Neil describes a basic buy/sell rule:

> Since successful stocks tend to move up 20 to 25 percent, then decline, build new bases and, in some cases, resume their advances, buy each stock at the exact pivot buy point and have the discipline not to pyramid (buy more at a higher price) or add to your position more than 5 percent past that point. Then sell each stock when it is up 20 percent. And, of the other corollary: Cut all losses at 8 percent off the buying price.

There are several advantages to this plan, but the primary one is that it puts money to its most efficient use. The weaker performers feed the better performers.

Many market-leading stocks go through "climax top," which are rapid accelerations after an advance of many months. Here are the signals:

1. Largest daily price run-up.

2. Heaviest daily volume.

3. Exhaustion gap: A rapidly advancing stock is greatly extended from its base and then opens up a new day higher yet.

4. Climax top activity: A stock's advance gets so active that it has a rapid price run-up for two or three weeks at a spread greater than any previous week prior to the original move.

5. Signs of distribution (selling).

6. Stock splits.

7. Increase in consecutive down days.

8. Upper channel line.

9. 200-day moving average line.

10. Selling on the way down from the top.

Low volume and other weak action:

1. New highs on low volume.

2. Close at/near day's low.

3. Third/fourth stage bases: The third new base becomes obvious to everyone in the market. Sell when your stock makes a new high off a third- or fourth-stage base (i.e., its third or fourth new base).

4. Signs of a poor rally: an unsustainable rally will have a lot of selling near the top.

5. Decline from the peak.

6. Poor relative strength.

7. Lone Ranger: Only one important member in an industry group has price strength.

Breaking Support:

1. Long-term upward trend line is broken.

2. Greatest one-day price drop.

3. Falling price/heavy weekly volume.

4. 200-day moving average line turns down.

5. Living below 10-week moving average.

Other Pointers:

1. If you cut all losses at 7 or 8 percent, take a few profits when up 25 or 30 percent.

2. Consider selling if a stock runs up and then good news or major publicity is released.

3. When it's obvious to *everyone* that a stock is going higher, sell, because it is too late.

4. Sell when quarterly earnings percentage increases slow materially for two consecutive quarters.

5. Be careful of selling on bad news or rumors.

6. Learn from your past mistakes.

Sometimes it is important to be patient and hold a stock. Specifically, buy growth stocks whose potential price target can be projected accurately. Also, with every new purchase, draw a red line — a defensive sell line — on a chart at 8 percent below the buying price. On the other extreme, never allow a stock that rises 20 percent to fall into the loss column. Also, allow major advances to take shape. Don't take profits during the first eight weeks of a move unless the stock is in trouble.

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Other Important Questions: Should You Diversify, Invest for the Long Haul, Sell Short, etc.?

Many investors overdiversify. The best results are achieved through concentration, by putting your eggs in a few baskets that you know very well. The desire to hedge risk by spreading it out over many stocks is understandable, but it also means that you have that many more stocks to keep track of and industries to become knowledgeable about. Broad diversification is often a hedge for ignorance. Diversification itself is sound as long as you don't overdo it and diversify with a plan.

How about timing of purchases? Using a follow-up purchase plan will help you keep more of your money in a few of the best stocks. With such a plan you make small additional purchases of a stock that has advanced 2 or 3 percent past your original purchase or most recent price. Of course, don't chase a stock past a correct buy point. This is better than haphazard diversification; this focuses the diversification on quality and profitability.

Should you invest for the long haul? Actually, the holding period isn't the issue. Profitability is the issue, and you achieve it by buying the right stock at precisely the right time. Conversely, a well-run portfolio should not have a loss carried on for many months, so length of ownership is driven by profitability.

Should you day trade? You are dealing with fluctuations that are harder to read than basic trends over a longer period of time. If done with real skill, some forms of day trading can work for some people, but they require a lot of skill.

Should you use margin? In the first year or two while you're still learning, it's most prudent to operate on a cash basis. After a few years of experience, a sound plan, and a good set of buy and sell rules, you might consider buying on margin. Remember: this means you are borrowing money from your broker. A fully margined account means that 50 percent of the money has been borrowed. Most important, cut losses short without exception.

Never answer a margin call. If a stock in your account collapses in value to where your broker asks you to put up money or sell stock, sell stock. The market is telling you that you made a wrong choice. Putting more money after it will just make it worse.

What about short selling? Short selling is the reverse of the normal buying pattern. You sell the stock (instead of buy it) even though you don't own it and must borrow it from your broker — in the hope that it will go down in price, at which point you can "cover your position" by buying the stock at a lower price and pocketing the difference. If you engage in this approach, don't do it in a bull market. The most effective time to do this is at the beginning of a general market decline, which means you must be reading the chart to track overall performance. Two typical chart patterns are the head and shoulders pattern and the cup with handle in a third or fourth stage.

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How to Read Charts Like an Expert and Improve Your Stock Picks and Timing

Charts are your investment road map. They tell you where your stocks are at all times. Chart patterns (or bases) are simply areas of price correction and consolidation.

Important questions to be able to answer from the charts are:

- Are price and volume movements normal or abnormal?
- Do movements signal strength or weakness?
- Is a stock in the proper position for a buy or, even though an otherwise "good" company, is it extended too far?

In the stock market, history repeats itself. Be aware of precedents.

The most common pattern, the "cup with handle," looks like a side view of a cup. Cup patterns can last from 7 to 65 weeks, but most run three to six months. The usual correction from the absolute peak (top) of the cup to the low (bottom) point ranges from 12 percent to 33 percent. A strong price pattern should have a clear and definite trend upward prior to the beginning of the base pattern. In most cases the bottom should look like a "U" rather than a "V." This part of the pattern is a needed natural correction.

The formation of the handle area generally takes one or two weeks and has a downward price drift or shakeout, where the price drops below a prior low point in the handle. This happens near the end of its down-drifting movement. Volume will dry up noticeably near the lows in the handle's price pullback phase. When handles do form, they must occur in the upper half of the base structure of the cup, and the handle should be above the stock's 200-day moving average.

Constructive patterns have tight price areas — small price variation from high to low for the week. If the stock has a wide price pattern every week, it will have been in the market's eye and will fail when it attempts to break out. When a stock forms a proper cup-with-handle pattern and then charges through an upside price point — the pivot point or line of least resistance — the day's volume should increase at least 50 percent above normal. Most of the increases are generated by professionals because it tends to appear risky to the general public to buy a stock just as it has hit a new high. The winning individual investor waits to buy at these exact pivot points.

Nearly all proper bases will show a dramatic dry-up in volume for one or two weeks along the very low of the base pattern and in the low area of the handle. The combination of tightness in prices and dried-up volume is generally quite constructive.

Another valuable clue is the occurrence of big spikes in daily and weekly volumes. Volume is the best measurement of supply and demand and institutional sponsorship. The fact that a stock has closed up on heavy volume for several weeks

in a row is a healthy sign.

There is an upside to market corrections. Eighty percent of the time, price patterns are created during periods of corrections, so you shouldn't give up on intermediate-term selloffs or bear markets. Bear markets can be as short as 3 to 6 months or, more rare, as long as two years. Bear markets create new bases on new stocks that could be the next cycle's winners.

Other patterns to look for include:

- **Saucer with handle: Similar to the cup with handle, in this pattern the saucer part tends to stretch out over a longer period of time.**
- **Double-bottom price pattern: This looks like the letter "W." They may also have handles. In theory, this is not as powerful a pattern, since the stock falls back twice. The pivot point is on the top right side of the "W" and should be equal to the tip of the middle part of the "W."**
- **A high, tight flag: This pattern, which consists of an advance of 100 percent to 120 percent in a very short period of time and is followed by a sideways correction of no more than 10 percent to 20 percent, is very rare. It appears no more than once or twice in a bull market. This strongest of patterns is very difficult to interpret correctly.**
- **A base on top of a base: During the later stages of a bear market, a seemingly negative condition flags what may be aggressive new leadership in a new bull cycle. A powerful stock breaks out of its base and advances but is unable to sustain a normal advance of 20 percent to 30 percent and is pulled back by the rest of the general market.**
- **Ascending bases, like flat bases, occur midway along a move up after a stock has broken out of a cup with handle. It pulls back 10 to 20 percent after each advance, with each new base from the resulting pullback being higher than the previous one.**
- **Wide and loose price structures: These usually fail, but they can tighten up later. Nothing dramatic happens, though some buyers are lured into thinking a major advance is imminent.**

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It isn't enough to understand a method for selecting winning stocks. To improve your performance in the stock market — to make a big improvement — you need to apply all of what you've learned. Remember the simple acronym CAN SLIM. Each letter stands for one of the seven basic fundamentals of selecting outstanding stocks.

Most successful stocks share these seven common characteristics at emerging growth stages, so they are worth committing to memory. Repeat this formula until you can recall and use it easily:

- ***C*** equals *Current Quarterly Earnings per Share:* They must be up at least 18 or 20 percent. The higher, the better. Also, quarterly sales must be accelerating or up 25 percent.
- ***A*** equals *Annual Earnings Increases:* Require significant growth for each of the last three years and a return on equity of 17 percent or more.
- ***N*** equals *New Products, New Management, New Highs:* Look for new products or services, a new senior management team, or significant changes in industry conditions. Buy stocks as they begin to make new highs in price.
- ***S*** equals *Supply and Demand:* It doesn't matter whether a company has a large capitalization or a small cap, as long as it fits all of the other CAN SLIM rules. Look for big volume increases.
- ***L*** equals *Leader or Laggard:* Buy market leaders and avoid laggards. Buy the No. 1 company in its field. Most leaders' Relative Price Strength Rating will be 80 or 90 or higher.
- ***I*** equals *Institutional Sponsorship:* Buy stocks

with increasing institutional ownership and at least a few sponsors with top-notch recent performance records.

- ***M*** equals *Market Direction:* Learn to determine overall market direction by accurately interpreting daily market indices' price and volume movements, and the action of individual market leaders. This can determine whether you will win or lose.

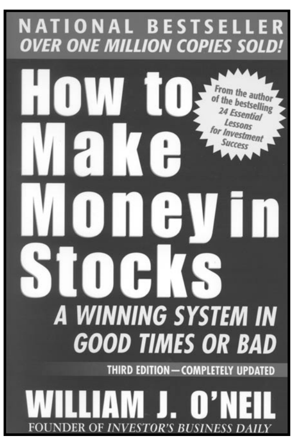
By using this simple, proven, and extremely powerful method, you can make money in stocks in any type of economy.

ABOUT THE AUTHOR

William J. O'Neil started in the stock market with a small $300 investment that launched what today is considered the premier source of investment research and education to individual investors and professional money managers.

He started William O'Neil + Co., Incorporated and became one of the youngest ever to buy a seat on the NYSE. In 1963 his company developed the first computerized database on the securities market. Today, over 600 of the most influential institutional money managers use William O'Neil research services. And the database, established almost 40 years ago, has grown to become the most comprehensive equity database in existence today, tracking over 200 data items for over 10,000 companies

In 1984 Mr. O'Neil launched *Investor's Business Daily®,* a national daily newspaper. Today, with nearly a million daily readers it is considered one of the most useful investment research tools available.



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The key to making money investing in stocks is remaining in the stock market; your length of â€œtime in the marketâ€ is the best predictor of your total performance. Itâ€™s critical to understand how your emotions can fool you into moving in and out of the stock market at the worst possible times, missing out on that annual return. (First things first: You need a brokerage account to invest â€” and thus make money â€” in the stock market. If you donâ€™t have one, hereâ€™s how to open one. It takes only 15 minutes to set up.) To make money investing, time in the stock market is critical. More time equals mo