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—Burton G. Malkiel, author of *A Random Walk Down Wall Street*

THE LITTLE BOOK

of

STOCK
MARKET
PROFITS

*The Best Strategies of All Time
Made Even Better*



MITCH ZACKS

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OF
STOCK MARKET
PROFITS

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Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

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Library of Congress Cataloging-in-Publication Data:

Zacks, Mitch.

The little book of stock market profits : the best strategies of all time made even better / Mitch Zacks. — 1

p. cm. — (Little book, big profits series)

ISBN 978-0-470-90341-4 (hardback); 978-1-118-19241-2 (ebk); 978-1-118-19243-6 (ebk); 978-1-118-19244-3 (ebk)

1. Stocks. 2. Investment analysis. 3. Speculation. I. Title.

HG4661.Z33 2011

332.63'22—dc23

2011033520

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

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Introduction



AS THE OLD JOKE GOES, THE BEST WAY TO MAKE A SMALL fortune in the stock market is to start with a large fortune. Given the volatility and sharp downturns in the market since the 2008 financial crisis, it's understandable that many investors might be wary about investing in equities these days.

With the market under intense pressure following the historic downgrade of the United States' credit rating, equity investment is not a hot topic. Many pundits argue that the malaise in the market is reflective of a declining American empire. They point overseas toward the East or bury their heads in the sand to look for shiny rocks called gold. This negative sentiment—while understandable—is actually very good news for investors. Stocks, currently, are on sale.

This is not the first time, nor the last, that stocks will likely prove to be a good investment. In fact, since World War II, the U.S. stock market has been able to generate annualized returns that are about 6 percent over the rate of return of Treasury bills.

These stock market returns occurred despite numerous obstacles. Over the past 60 years, we have witnessed the Cold War, the Cuban Missile Crisis, the Vietnam War, the Korean War, the stagflation and oil crisis of the 1970s, the Watergate scandal, double-digit interest rates, the Stock Market Crash of 1987, the dot-com crash in the early 2000s, the real estate crash, the financial implosion of 2008, as well as massive political upheavals, cultural revolutions, and manias—in the face of all these obstacles, the market marched forward. The future will bring its share of problems and I have no doubt they will be just as serious as what we have experienced in the past. But just as in the past, I am confident they will be overcome.

As always, the best way to generate returns in the equity markets is to invest and to stay invested over a long period of time. Rapid-fire day trading, in particular, is far too volatile and risky to actually generate long-term wealth.

The key to equity investing is to not become too exuberant in the periods of stock market gains and to not become too despondent when the market sells off. Levelheaded commitment to equities is what is necessary to generate real returns.

You must have the strength of mind to look past the volatility of the present and realize that if you invest over the long term, substantial returns can be generated by holding equities.

Based on a foundation of academic research, *The Little Book of Stock Market Profits* explains how to build long-term wealth in the equity markets. The book focuses on investment strategies that will help an investor prudently navigate the market regardless of its level of volatility. Each chapter focuses on a specific means of selecting stocks that can potentially generate *alpha*, or the value that a professional investor adds to a fund's return. Alpha is the white whale of the investment business. It is what professional investors devote their careers to discovering. Quite simply, the search for alpha is a quest to find a means of selecting stocks that will generate performance greater than the level of risk borne. The search for alpha is not so much trying to find a free lunch in the equity markets, as much as it is the art of using statistics to identify groups of stocks that will beat the market.

The Little Book of Stock Market Profits identifies and analyzes the major methods documented by finance researchers that can be used by investors to generate alpha. My book draws upon the survey of over 650 research papers published over the past 20 years that are summarized in *The Handbook of Equity Market Anomalies* also published by John

Wiley & Sons (2011). In *The Little Book of Stock Market Profits*, I synthesize, explain, and interpret the cutting-edge academic research relevant to equity investing and combine it with my own insight gained as a portfolio manager.

If implemented correctly, the information in this book could help you beat the market. Here is a breakdown of what's discussed in each chapter:

- Chapter 1 examines how best to use sell-side analyst recommendations in an investment process. The answer is counterintuitive, but nonetheless powerful.
- Chapter 2 asks whether it makes sense to tilt a portfolio toward smaller cap stocks. The results are not what conventional wisdom indicates.
- Chapter 3 explains how earnings estimates can generate alpha. I have been using earnings estimate revisions as a source of alpha for more than a decade and a half and am a firm believer in their efficacy.
- Chapter 4 looks at whether price momentum can be used to identify stocks that will outperform the market. New research indicates that if you are not entering a recession, price momentum can be a very effective tool.
- Chapter 5 is about piggybacking. We look into whether piggybacking on the trades of insiders can help increase returns. It seems reasonable that if

the CEO of a company is buying his own stock, that perhaps you should as well.

- Chapter 6 covers the signaling effects of net stock issuance activity. Hopefully, by the end of this chapter you will agree with Groucho Marx and pass on the next IPO offered to you but embrace a company engaging in a stock buy-back.
- Chapter 7 shows that excess returns may be generated by focusing on the quality of earnings a company generates. The biggest challenge is whether the results have already been arbitrated away by professional investors.
- Chapter 8 illustrates the importance of using valuation metrics in trying to find stocks with positive alpha. It appears that Graham and Dodd's insights were eerily prescient.
- Chapter 9 focuses on a phenomenon called post-earnings announcement drift and illustrates how an investor can use earnings surprises to generate returns that are higher than one would expect, given the risk being taken.
- Chapter 10 looks into whether seasonal timing strategies can beat the market. Generally, I tend to discount market-timing strategies, but the results may be very interesting to futures traders.
- Chapter 11, the last chapter, examines the creation of multi-factor models that can generate excess

returns. One of the multiple-factor models works better among growth stocks, while the other is more appropriate for value investing.

By the end of this book, you will hopefully understand how various methodologies can help you beat the market. Most likely the next decade will prove to be a very good time to start implementing these strategies.

I would venture to say that, given the level of pessimism permeating the country and the markets, savvy investors entering the equity markets and holding stocks over the next decade will be nicely rewarded. Most likely, equity returns over the next 10 years will be greater than they have been over the previous 10 years, which by any measure has been a dreadful decade for equities.

What you will find as you read through these chapters are two things. First, the market, while being brutally efficient, has inefficiencies that can be exploited over time to generate excess returns. Second, in order to realize these excess returns, an investor must be incredibly patient. You will find that investment strategies which generate alpha have long periods of outperforming and underperforming the market.

For those with the knowledge and the will to persevere, this book will show that it is possible to generate excess returns. Let's get started.

Chapter One



The Crystal Ball of Wall Street

Analyst Recommendations and the Future

IT IS VERY HARD TO PREDICT THE FUTURE. Think about something you like to analyze for fun—such as following the local sports team. In Chicago there are two baseball teams, the White Sox and the Cubs. The two teams face off against each other in what is called the Crosstown Classic. Now no matter how die-hard a Cubs fan you are or what your knowledge of the White

Sox is—trying to predict which team will beat the point spread is incredibly difficult. No matter what you think you know about the Cubs, the information is likely reflected in the point spread.

Trying to beat the market is very similar—a stock may in fact be a good buy due to various fundamental reasons, but this information is likely already reflected in the stock's price. If you're trying to select a stock to outperform the market, find a stock for which new information is not currently reflected in the stock's price. Brokerage firms attempt to do this by hiring research analysts.

An investor's first introduction to the work of research analysts is often listening to and acting on a stock recommendation provided by a full-service broker. An investor will purchase a stock because the research analysts at the broker's firm have issued a recommendation to buy. Sometimes a recommended stock will go up, sometimes it will go down. Perhaps the broker will provide a string of prescient recommendations. More likely than not, though, acting on the broker's recommendation will not result in a windfall for the investor. The next logical question for the investor is whether this is because of the broker, the research analysts at the brokerage firm, or simply due to being a small-fry client to the brokerage firm. The answer to this question lies at the heart of the study of investment strategies based on analysts' recommendations.

Meet the Analyst

Meet Matt, an analyst working at a Wall Street brokerage firm. Most likely he has graduated from a top-tier MBA program within the past decade or two. Since graduating from business school, Matt has been following the same group of 10 stocks in the enterprise software sector. Unlike an analyst who works for a mutual fund and who has to be moderately familiar with a large number of stocks, Matt is likely one of five or six people in the country who is an expert on the 10 enterprise software companies that he follows.

Matt spends his time researching the companies he follows, meeting with the senior-level management, analyzing the industry, and trying to predict which of the companies will be successful. He often talks directly with high-level investors regarding the prospects of the companies that he follows, and he writes extensive research reports on what's going on with them.

The research reports written by analysts like Matt usually contain an estimate of what a company is going to earn on a per-share basis over the next two fiscal years; an estimate of how fast the company is expected to grow its earnings over the next five years; a recommendation of whether an investor should buy, hold, or sell the stock; a target price indicating

what the analyst feels the stock should trade at over the next year; and last, a detailed explanation illustrating how these results are derived. The report usually contains a spreadsheet that shows the financial estimates behind the earnings projection, and it can be anywhere from a few pages to a short treatise to a semiannual opus.

These research reports are then provided to investors by the brokerage firm in exchange for trading revenue. This means that retail and individual investors who execute trades through a brokerage firm usually can access the firm's proprietary equity research.

However, many retail investors do not spend the time and effort to actually read the report; instead they tend to focus on the recommendation of the report and blindly follow the advice. Unfortunately, this is far from the best way to use the research.

Listen—But Only if Simon Says “Change”

The purpose of the recommendation is to boil down the fundamental research of the analyst into one actionable suggestion. Do you buy, hold, or sell a stock? Unfortunately, the answer is not always clear. Here's a hint if you want the CliffsNotes version: Focus on recent recommendation changes from analysts with good track records in small-cap stocks.

Analysts in the United States are collectively paid more than \$7 billion each year to tell investors which stocks to buy and which to sell. At the most basic level, there has to be some value to the research analysts' work. If there was not any value in the work, it is unlikely that investment banks, which are usually focused on the bottom line, would continue to pay analysts so much. Research seems to back this up—the analyst recommendations are useful in certain ways.



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There are a few firms worldwide that track analyst recommendations and their performance in the marketplace. One such company is my firm, Zacks Investment Research. In fact, we were the first firm in the country to

begin tracking analyst recommendations; as a result, our database of recommendations has the longest history of any company, dating back to the early 1980s.

Research shows that:

1. Changes in analysts' recommendations can be used profitably. The key here is whether an analyst has provided new information to the marketplace by changing his view on a stock.
2. Transaction costs can dramatically reduce the return of recommendation-based strategies.
3. Changes in analysts' recommendations work better with smaller companies (that is, smaller capitalization stocks).
4. You can make more money by using recommendation changes in combination with other criteria.
5. Some analysts tend to have a greater effect on stock prices than others. One way to determine which analyst to follow is to track the analyst's historical accuracy in making stock recommendations.

After roughly two decades of research it looks like analysts' recommendations can be used profitably if the focus is on changes in recommendations as opposed to the level of the recommendation. It is more important if an analyst has recently changed his recommendation

than if the analyst has been indicating a stock is a strong buy for the previous six months.

Tale of the Tape

One of the simplest investment strategies is to create portfolios based upon what analysts are recommending. That is, you buy the stocks the analyst tells you to buy and sell the stocks the analyst tells you to sell. The basic idea here is that the analyst's recommendation has some predictive ability—that is, those stocks an analyst recommends as a buy should outperform, while those stocks an analyst recommends as a sell should underperform.

Let's say that every calendar quarter you sort all the stocks for which analysts have issued recommendations for into two groups. The first group consists of the top 10 percent of stocks for which analysts are the most positive, and the second group consists of the bottom 10 percent of stocks for which analysts are the most negative. You buy and hold each portfolio for a quarter, and then you create the portfolios again next quarter with new data. From 1990 through 2010, the basket of stocks for which analysts were the most positive outperformed the basket of stocks for which analysts were the least positive in 14 of the 21 years. The strategy of going long stocks recommended by analysts and shorting the stocks analysts indicated you should avoid worked from 1990 to 1997, but then the strategy fell apart.

Let's repeat the experiment from before. This time, instead of sorting the stocks based on the level of recommendations, sort the stocks into 10 groups based on the changes in recommendations that occurred over the past month before the end of the quarter.

The good portfolio consists of the top 10 percent of stocks receiving the strongest magnitude of recommendation upgrades over the past month, and the bad portfolio consists of the bottom 10 percent of stocks that are receiving the largest magnitude of recommendation downgrades. In this case, examining the same time period as before, from 1990 through 2010, the basket of stocks consisting of those stocks receiving strong recommendation upgrades outperformed the basket receiving substantial recommendation downgrades in 19 of the past 21 years.

Results become even stronger when the creation of the portfolios is closer to the time of the recommendation changes. Studies have shown that excess returns increase substantially when the rebalance frequency—the period in which you are creating the basket of stocks based on changes in recommendations—is shifted from monthly to weekly, and it increases again when the rebalance frequency is shifted to daily. However, the data show that the returns from recommendation-based strategies are very volatile over time and are highly dependent on transaction costs.