"The stock market is like a woman. You observe her. You respond to her. And you respect her."
Richard Driehaus

" Envision a snowball rolling down a hill: As it rolls along, it picks up more snow, which causes it to move faster, which causes it to pick up even more snow and move even faster".

Wayne Thorp – AAII, "A LOOK AT MOMENTUM INVESTING"

Growth Strategies : The search for the elusive ten bagger

There's an old adage in the movie business that 9 in 10 movies in a studio's portfolio of releases will lose money – but the 1 in 10 that is a huge success will probably more than pay for all those losses combined and still leave the cigar smoking media magnates with a tidy overall profit.

This apocryphal 1 in 10 success rate finds something of an echo in a more esoteric term , that of the Pareto principle. Otherwise known as the 80/20 rule or law of the vital few, this is widely used in business to describe how a small number of successful phenomena can produce a disproportionately large total impact. Many a management seminar has been built around the idea that 80% of your company's sales come the top 20% of customers.

The same principle could be applied to investor's portfolios – many professional investors such as George Soros or even Warren Buffett admit that much of their long term success can be accounted for by a small number of stunningly successful, hugely profitable investments.

For most private investors this translates into one much used , and abused, word – the wonderfully elusive tenbagger of stock market lore! Peter Lynch coined this term to describe the kind of share that goes up by more than ten times – a curious origin for the term given that Lynch was far from being a spivvy, growth orientated investor. Undeterred by his reputation as a value orientated investor Lynch famously listed his key criteria for finding those elusive tenbaggers – his list of factors included

- Look at small companies. " Big companies don't have big stock moves….you'll get your biggest move sin smaller companies".
- Fast growers where earnings are growing by more than 20 to 30% per year
- Look for insider buying and share buybacks.
- Diversify and hold plenty of stocks and different kinds of risk in your portfolio

But Lynch had two final criteria waiting in the wings, criteria that are not so widely referred to today by breathless growth fiends…..

- Buy stocks from dead industries with dull products and dull names
- Buy stocks from sectors where analysts don't bother looking

david 27/1/10 20:36
Comment: Referred to by Harry Domash in The Basics
How to invest like Peter Lynch at http://moneycentral.msn.com/content/Investing/Findhotstocks/P87270.asp

Given Peter Lynch's background in value orientated investing these last two criteria shouldn't have surprised anyone – but it's fair to say that very few growth investors bother with the last two criteria. Yet the search for the tenbagger has taken on added urgency in today's volatile, ultra short termist markets and the elusive creature is today more likely to be discovered at the Tech sector watering hole. At some point in the mid 1990s investors woke up and noticed two inter-related phenomena occurring within modern capitalism ; namely the rapid growth of the technology sector which was in turn is fuelling rapid increases in corporate productivity (or at least that's the myth) and profitability aided by out-sourcing, restructuring, refocusing and greater emphasis on shareholder returns.

A whole new kind of super growth company – the shooting star that produces that tenbagger return – had emerged, with most of the candidates being based in the US of A. The most articulate gudie to finding these ten baggers is the big daddy of private investor friendly web sites, Motley Fool.

Back in 2004 David Forrest, co-founder of the site (which by the way boasts a superb bulletin board on screening strategies and a great US screener at http://caps.fool.com/Screener.aspx) defined precisely what he meant by something he liked to call High Octane Investing. Forrest is always a hugely illuminating writer and his column singled out that one of the best ways to track down fast rising stocks is to find, well, find ….fast rising stocks. His point was that investors who are buying stocks where the share price was rising fast are trying to tell us something and that something is that the company is growing fast. The key measure here is something called Relative Strength and in Forrest's case he was interested in developing a version of the measure of Relative Strength used by a US newspaper called Investor's Business Daily – we'll run into the fine organ later in this chapter hen we examine the CAN SLIM methodology.

The point of Forrest's investigation was to come up with ideas for tomorrows ten baggers. But as Forrest wryly observed " its never entirely clear if the companies achieving high RS status [IBD has a big , closely watched ranking system for RS] are here because the underlying business is performing exceptionally well and the stock is rising [the theory behind growth investing] or if the somewhat self fulfilling prophecy of momentum madness is at work".

david stevenson 25/13/78 15:14
Comment: "High Octane Investing " David Forrest, www.fool.com, Feb10th 2004

Regardless of his justified suspicions Forrest persevered and soon came up with his own shortlist of stock ideas. One company in particular shows that the idea behind a tenbagger , namely the fast growing, technology stock has not entirely vanished even after the Dot.Con meltdown at the beginning of the last decade. The company was, and is, Netflix. It's an internet based rival to the bricks and mortar video rental outfits like Blockbuster and over the last decade has grown at an astonishing rate ! NetFlix is an archetypal super growth stock, a shooting star and for investors who bought at the right price, a tenbagger ! Floated on NASDAQ in 2002 at around $8 its kept on increasing in price throughout the first decade of the new millennium even whilst most other technology stocks sank into oblivion – it finished the decade at around $56. But many investors had ignored its IPO price and had picked up the shares in the $3 to $6 trading range back in 2002 and 2003 – bagging more than 10 fold increases by the end of the decade.

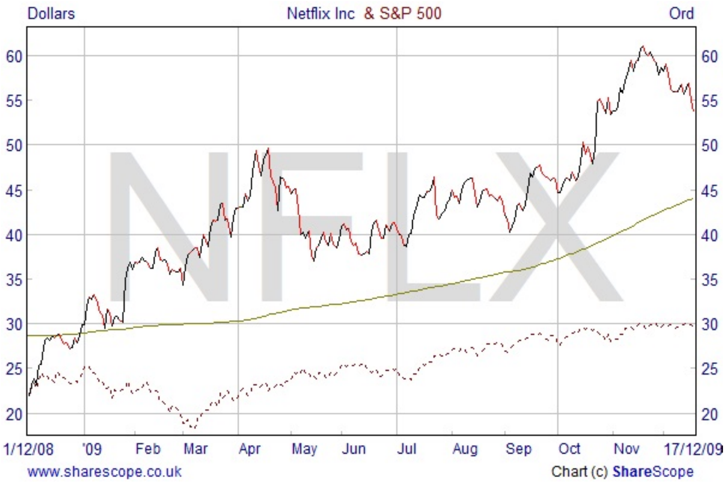
That massive increase in the share price was largely a result of one simple inescapable fact – here was a company that was inexorably turning its innovative business model into a huge profits machine in the same way as predecessors such as Amazon and Google. The business was, and is, simple – you log onto to their web site, pay a monthly fee and in return they send you DVDs through the post. Back in 2002 Netflix boasted sales of just over $200m and a pre-tax loss of $21m – by the end of 2008 sales were $1.3bn and profits had hit $131m, with most analysts expecting another big increase in the 2009 financial year.

This inexorable rise in profits also prompted another feedback loop – as it grew in scale and profitability, more and more analysts started following the shares, prompting in turn more and more institutional interest. Suddenly brokers notes started emerging that suggested a rapid increase in earnings over the next few quarters and years. The table below is from the US technical analysis web site www.clearstation.com and shows the average or consensus estimates for brokers covering Netflix in 2008 and 2009 on a quarterly basis – you'll immediately notice that the brokers estimates are constantly growing but the actual earnings produced continued to smash these forecasts. The last box measures the earnings surprise – the difference between the consensus estimate and the actual earnings produced, and every quarter the figure is positive.

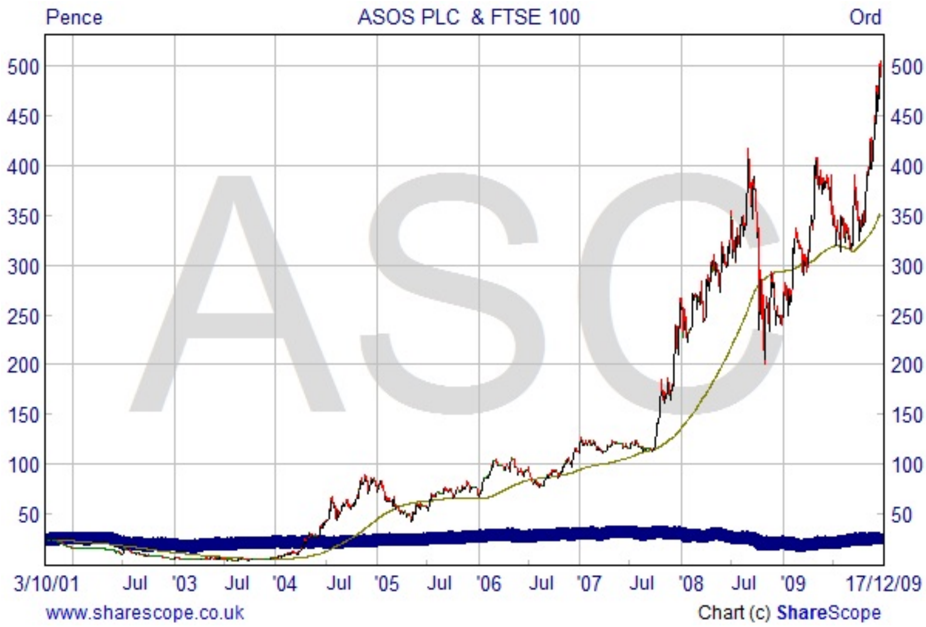
Quarterly Earnings Surprises	Estimate	Actual	Surprise(%)
Quarter Ending 09/2009	0.46	0.52	13.04%
Quarter Ending 06/2009	0.51	0.54	5.88%
Quarter Ending 03/2009	0.32	0.37	15.63%
Quarter Ending 12/2008	0.34	0.38	11.76%
Quarter Ending 09/2008	0.31	0.33	6.45%
Note: EPS excludes non-recurring items; see Earnings Per Share in Profile for EPS including non-recurring items. (Note: EPS is undiluted)			

Needless to say with this kind of seemingly perpetual growth, the analysts keep on increasing their rate of growth in earnings to catch up. The net effect of all this growth was obvious – the shares continued rising throughout 2008 and 2009 as first earnings grew and then the Price to Earnings ratio attached to the shares also increased as investors scrambled into the stock pushing up its market ratings multiple..

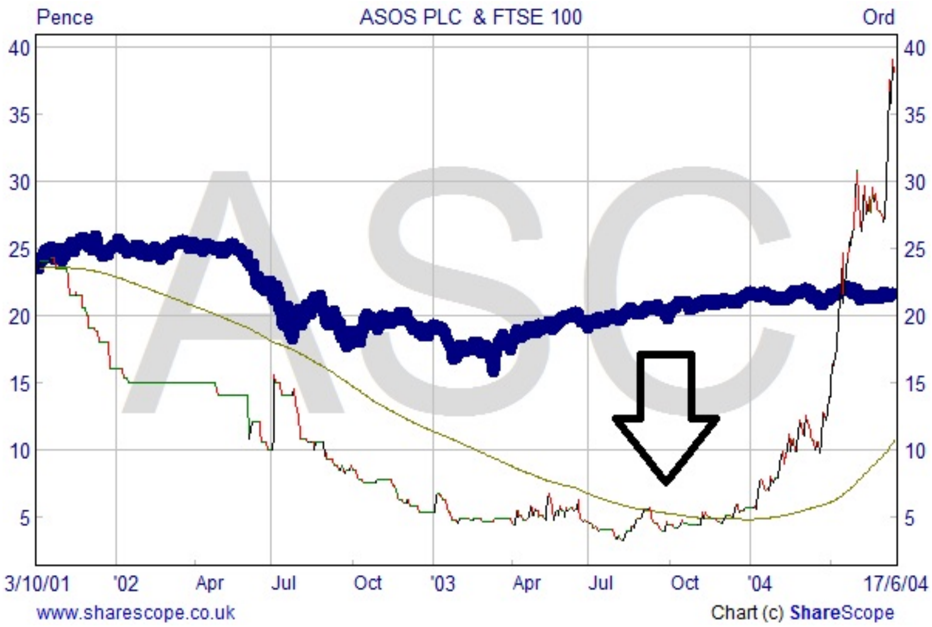
The graph below shows the share price of NetFlix for these two years through to mid December 2009 relative to the S&P 500 index, which is the dotted line at the bottom, a dotted line that spent much of 2008 and 2009 going nowhere! The straight thin line in the middle shows the 200 day moving average – Netflix shares were constantly smashing through this barrier, indicating enormous relative strength. Over the last few years the PE ratio for this stock has also varied hugely, moving within a 20 to 50 PE range – indicating that at varying points the market was willing to pay as much as 50 times earnings for this shooting star.



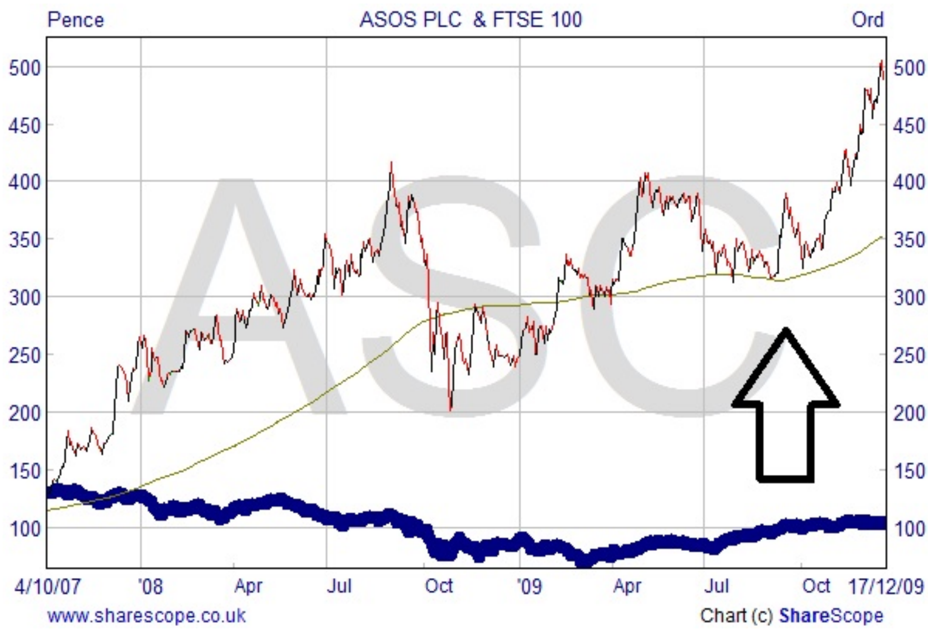
But it would be wrong to assume that this kind of astonishing growth only ever happens in the US – these super growth stocks also occasionally pop up in the UK as well. If the success of Netflix finds any echo here in the UK, it's probably with another internet based sensation called ASOS (it used to be known as As Seen On Screen). This internet based fashion store has been a truly astonishing success – it truly is a veritable ten bagger floated in 2001 at around 23p a share, a long way from its end 2009 price of just under 500p. The graph below tells the story of ASOS and its shares – after a quiet few years through to 2004, the shares began to pick up momentum at the beginning of 2004, moving into veritable over-drive in the summer of 2007 at which point the shares shot above 115p to hit a peak of over 400p just over 12 months later. The big thick (blue) line at the bottom by contrast is the progress (of sorts) of the FTSE 100 index !

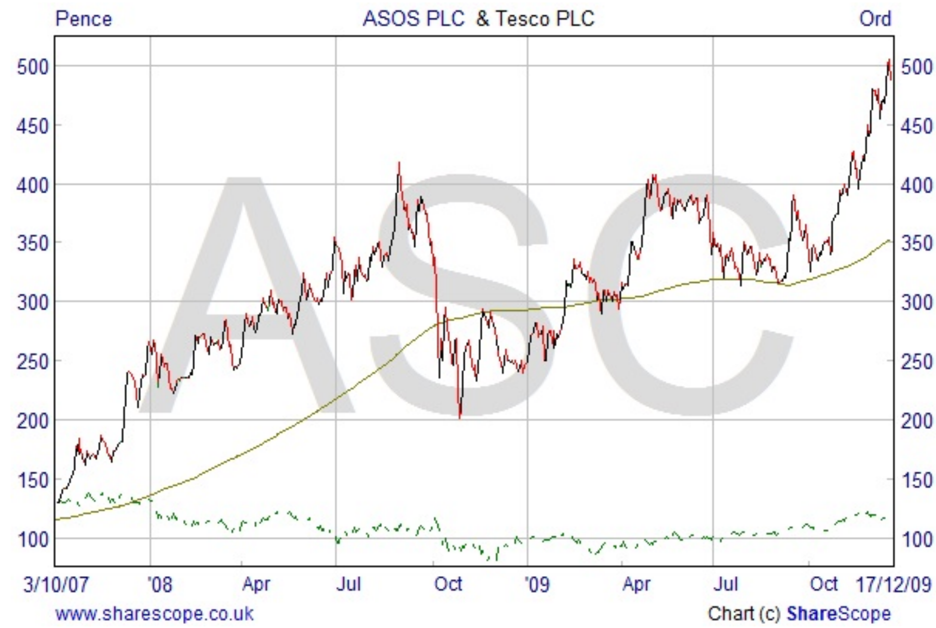


Before we look in detail at the cause of this momentum its worth dwelling just a bit longer on that pick up in momentum. The first graph below shows ASOS shares from 2001 through to summer 2004 – the big thick line on the top is the FTSE 100 index benchmark while the thin straight line in the middle is the 200 day moving average. As you can see ASOS shares underperformed the wider market for most of this period..



By the summer of 2007 though this relative under-performance had vanished and there was quite literally nothing to stop ASOS – even a disastrous warehouse fire in Hemel Hempstead in 2008 only dented the shares progress for a few months !





The table below spells out the cause of this success – ASOS has turned into a phenomenal money making machine. Sales have shot up from under £1m in 2001 to £165m in 2009 while profits have leapt up from a loss of £500,000 to £14.1m over the same period. In every year between 2001 and 2009 both turnover and profits have increased year on year.

EPIC	Close	Price %	Share	Price%	Price%	Capital (£m)	NTAV	ROCE (%)	PCF
			Price p	1 year ago	5 years ago		ps (p)		
ASC	4.87	-3.6	1.17	95.58	476.33	356.2	34	59.1	26.9
Projected	Forecast	EPS							
P/E	EPS Growth	2009	2008	2007	2006	2005	2004		
26.89	36.58	13.6	6.95	3.4	2	1.3	0.99		
Turnover (millions) £m									
2009	2008	2007	2006	2005	2004	2003	2002	2001	
165.4	81.04	42.61	20.37	14.42	8.956	4.104	1.702	0.335	
Profit									
£m 2009	2008	2007	2006	2005	2004	2003	2002	2001	
14.1	7.31	3.37	1.405	0.88	0.26	-1.7	-1.11	-0.49	

It’s little wonder then that that analysts have woken up to the potential of this small cap - the table below shows broker earnings estimates for ASOS at the tail end of 2009. The consensus is a buy with earnings thought likely to increase from 13.6p in 2009 to 17p in 2010.

BROKERS CONSENSUS EARNINGS DECEMBER 2009					
Broker name	Opinion (abbrev)	Date forecast	Forecast Dividend	Date confirmed	Forecast EPS
Investec Securities	BUY	02/11/2009		12/11/2009	16.86
KBC Peel Hunt Ltd	BUY	11/09/2009	2	11/11/2009	19.7
Numis Securities Ltd	BUY	30/09/2009		10/11/2009	17.5
SG Securities	BUY	13/10/2009		10/11/2009	18.11
Shore Capital	BUY	06/07/2009		06/11/2009	19
Arden Partners	BUY	27/07/2009		03/11/2009	18
Singer Capital Markets Ltd	BUY	06/07/2009		03/11/2009	16.7
Evolution Securities Ltd	BUY	30/06/2009		02/11/2009	19.2
Seymour Pierce	BUY	07/08/2009		02/11/2009	17.9
Altium Securities	HOLD	06/10/2009		30/10/2009	17.1
Fyshe Horton Finney Ltd	HOLD	28/07/2009		28/07/2009	
Consensus	Buy				17.71

Spotting Growth Companies
Using both ASOS and NetFlix as examples its worth dwelling on the broad similarities – and probing the common forces at work.

In both cases the primary driver of growth has been the establishment of a successful brand – online and with a loyal and growing army of customers. This has in turn fed through into an almost perpetual growth engine for both sales and bottom line earnings – with both Netflix and ASOS net operating margins have also held relatively steady even as total sales have increased.

That earnings growth engine has then fed through into perhaps the sexiest game in stockpicking, the analysts estimate game - with a larger number of analysts following the stock as its prominence has increased. In the case of NetFlix those analysts have clearly failed to grasp the speed of the increase in earnings quarter on quarter, producing a constant series of surprises. In the case of ASOS the analysts have possibly been too cautious and there haven’t been too many surprises, although the shares have continued to head north regardless.

As the success of the business model becomes well known the ‘herd’ of fund managers and professional investors piles into the stock, pushing the share price inexorably higher – the sheer volume in the shares bears testament to this trend. As that momentum gathers pace investors less fixated on the fundamentals (which are beginning to look rather expensive compared to the share price) start to take an interest – as they see the ‘technicals’ of a share strengthen, these shorter term traders also start to buy the stock in the belief that the shares will continue to beat the wider market in relative terms. This last engine of momentum also helps explain why investors are suddenly willing to attach a much higher multiple – based on the PE ratio – on the shares!