



Investing in Growth Stocks

A Return to Basic Principles

by Kenneth S. Janke, Sr.

The past three years have been reminiscent of the mid-1970s, when most everyone was crying doom and gloom. During this period many individual investors and investment clubs abandoned the stock market, some never to return to this day. There may have been different circumstances 30 years ago, when inflation was running wild and the war in Vietnam was over, but one similarity was investor confidence — or the lack of it.

With that in mind, it was refreshing to come across the latest quarterly investment letter from David Wendell Associates with its focus on the basic principles of growth stock investing. The firm pointed out that current concerns, including recession, war, terrorism and economic weakness abroad, have been holding back share prices of leading growth companies for some time. Viewed from a longer-term perspective, however, share prices won't be held back indefinitely.

In support of that belief, the firm noted five fundamental principles of investing in growth stocks that have stood the test of time. NAIC investors shouldn't be surprised by any of them. They mesh well with the fundamental principles of investing NAIC has espoused for decades.

Fundamental Principles of Investing in Growth Stocks

The five principles are:

- Inflation and its effects on long-term objectives are important.
- Common stocks are an effective hedge against inflation.
- The long-term earnings growth rate of a company should be weighed against other underlying characteristics.
- The selection process should be rational and take into account the relative value of the stock.
- A consistent investment philosophy should be maintained throughout the ups and downs of the stock market.

Regarding the selection process, the newsletter also noted criteria NAIC members would find familiar in narrowing down the range of investment choices. The screening process included three simple tests: First, the company should have an annual average return on equity

of 15 percent or more during the last five years. Second, earnings per share growth should average at least 12 percent in the past 10 years. Finally, there should be no more than two annual earnings declines over the 10-year period.

Of the Fortune 500 industrial companies, fewer than one in six met the criteria when David Wendell Associates did the screening. That's less than 80 in total. They're the companies with favorable long-term characteristics. Of course, good investment decision-making goes beyond that. Another major consideration is market price. It has to be right because the greatest growth company in the world can be purchased at the wrong price, resulting in losses.

Sound Familiar?

If all this sounds a lot like what NAIC investors look for when using the Stock Selection Guide, it should — because it is. The SSG is divided into two parts: tests of management to help identify good companies, and consideration of stock price in relationship to historical values and potential future growth. The latter includes the possibility of a P/E enhancement that adds even greater value to earnings progress. It's something that should be looked at when preparing studies.

David Wendell Associates also offers some questions that investors should answer regarding companies they are seriously considering as growth stock investments. Do they have a dominant or leading position in their businesses? Are they financially strong, with little debt and high returns on equity? Does management have a clear-cut strategy? Is the company innovative and responsive to changing conditions? Is management working to enhance shareholder value rather than primarily itself?

The newsletter also pointed out that "a consistent investment philosophy should be maintained throughout the ups and downs of the stock market." That's following the first NAIC principle of regular investing. Don't be concerned about the immediate climate for investors. Look at the big picture and you'll eventually be rewarded with superior results. **BI**

Kenneth S. Janke, Sr., is chairman of NAIC's Board of Trustees and a member of BI's Editorial Advisory and Securities Review Committee.