research + insight

A well-thought-out investment plan includes establishing goals, implementing a strategy and monitoring your portfolio over time. Exposure to the stock and bond markets is an important part of the implementation strategy, and this section includes ideas and insights from third-party experts as well as Schwab's perspective to help you make sound investment decisions. Rather than presenting "hot tips," we offer information designed to help you create and maintain a diversified portfolio of stocks and funds with good prospects.

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FINANCIAL PERSPECTIVE

Sell Alerts
for Individual Stocks

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Investors are repeatedly told to employ a patient, buy-and-hold strategy when investing in stocks. Unfortunately, this advice is frequently misunderstood. Holding a constant portfolio allocation to equities is a sound strategy. But successful investors can't simply buy a bunch of individual stocks and forget about them. In a competitive global economy, the investment prospects of individual companies are continually evolving. To protect your investment capital, you must regularly re-evaluate your stock holdings for any negative developments. In this article, we provide a simple checklist to help you monitor critical changes in the investment merits of the stocks you own.

Negative catalysts

Often some type of negative "catalyst" stokes investor concern and drives stock prices down—even on quality firms that you feel have solid long-term competitive prospects. Focusing on the 2,000 stocks with the largest market capitalization over the period January 1990 to June 2008, Schwab research found that recent changes in corporate fundamentals and investor sentiment sometimes serve as that catalyst and trigger stock price weakness.

We've compiled several of the more critical catalysts into an eight question "sell alert" checklist that you can use to evaluate any stock.[1]

1. Is the quarterly inventory/sales ratio higher than it was a year ago? Investors fear inventory build-up might indicate weakening customer demand or that product prices might need to be cut to reduce excess inventories. Historically, stocks of firms whose inventory growth exceeds their revenue growth have underperformed 61% of the time in the following 12 months by an annualized average of 0.7%.

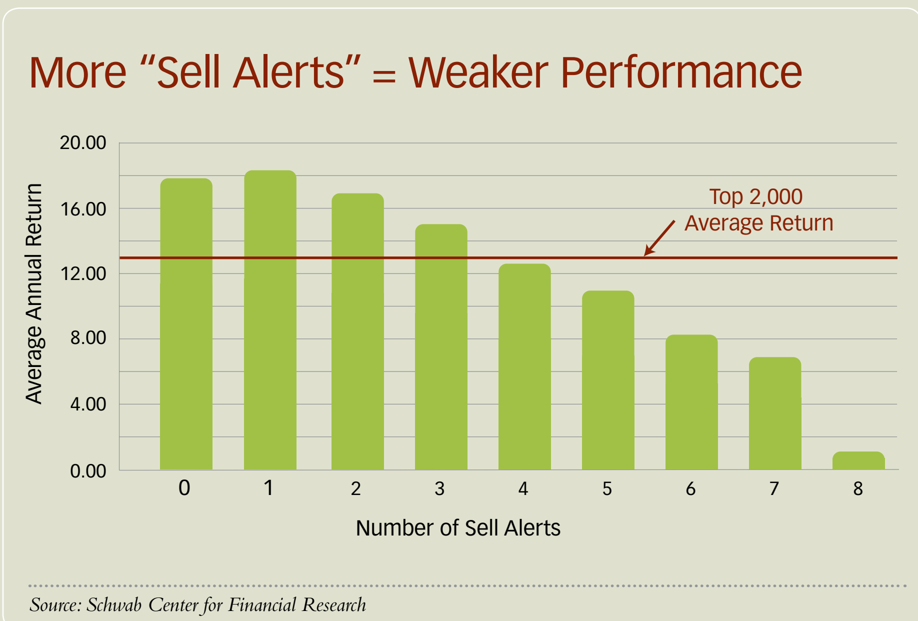
2. Is current quarterly cash flow from operations less than quarterly net income? Investors worry about the sustainability of earnings not fully backed by cash flow, and fear that management may be manipulating accounting rules to temporarily boost net income. Historically, stocks of firms that have reported net income exceeding operating cash flows have underperformed 71% of the time in the following 12 months by an annualized average of 2.1%.

3. Are current quarterly capital expenditures greater than current quarterly depreciation? Investors are concerned about the risk of uncertain future payoffs from heavy current expenditures and the lack of operating flexibility of capital-intensive firms. Historically, stocks of companies that have current capital investments exceeding the depreciation expense associated with past capital investments have underperformed 65% of the time in the following 12 months by an annualized average of 1.2%.

4. Is the firm's long-term debt greater than it was a year ago? Investors are concerned about whether the certain increase in interest expense will be covered by the uncertain payoff from management's use of the borrowed money. Historically, stocks of firms with increasing long-term debt have underperformed 69% of the time in the following 12 months by an annualized average of 1.1%.

5. Are shares outstanding greater than they were a year ago? Investors worry that share issuance is a sign that management feels its stock is a cheap source of capital, which could mean the stock is overvalued at the current price. Historically, stocks of firms with increasing common shares outstanding have underperformed 59% of the time over the following 12 months by an annualized average of 2.4%.

6. Is the change in the stock's price over the last six months less than that of the S&P 500 Index? Investors interpret poor price performance as a sign of potentially deteriorating fundamentals or weakening interest in the stock. Historically, stocks of firms with prices that have lagged the market have underperformed 70% of the time in the following 12 months by an annualized average of 2.3%.



STEVE LEONARD

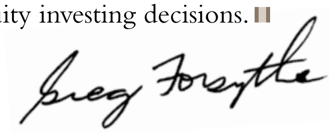
7. Have analyst earnings forecast revisions been mostly negative over the last quarter? Investors perceive brokerage analyst forecast cuts as a sign that the company is having fundamental problems and may be vulnerable to further cuts in earnings expectations. Historically, stocks of firms experiencing negative earnings forecast revisions have underperformed 76% of the time in the following 12 months by an annualized average of 1.2%.

8. Are total shares sold short greater than those of a year ago? Investors interpret the increasing pessimism of sophisticated investments such as hedge funds as a sign that a stock is overvalued or may be weakening fundamentally. Historically, stocks with increasing short interest have underperformed 73% of the time in the following 12 months by an annualized average of 1.2%.

"Sell Alert" score

While a "yes" answer to any one of these questions raises concern, the true power of this checklist comes from adding the number of "yes" answers to create a composite sell alert score for a given stock. The chart on page 34 shows the strong historical relationship between a stock's score and its subsequent performance.

Stocks with scores of four or more (four or more "yes" answers) have tended to underperform, while stocks with scores of six or more have tended to underperform by a wide margin. While we can't guarantee that future returns will follow this pattern, this research suggests that our sell alert checklist can be a useful, time-saving tool to help you make unemotional, objective decisions—a key to making informed equity investing decisions. ■



[1] *The data to answer questions 1 to 7 can be found under the "Quotes & Research" tab at **schwab.com**. After entering a stock's ticker symbol, click on a link under the "Growth & Earnings" tab for quarterly financial statement data. For analyst earnings forecast data, click on the Schwab Earnings Report under the "Reports" tab. For short interest data to answer question 8, visit nasdaq.com.*

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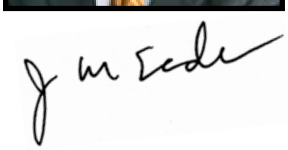
INVESTMENT INSIGHT

When the Fundamentals Fail

JOHN M. EADE, president and director of research, Argus Research Co., explains why it's a good idea to approach some low-priced stocks with caution.



GIL VAKNIN

Before they were finally taken over by the government earlier this year, the mortgage companies Freddie Mac and Fannie Mae were trading in the market on something other than the fundamentals. During the summer, they swung up and down between $25 and $4 per share.

The volatility attracted a breed of investor who likes to move quickly and tries to take advantage of rapid price swings. These are the same investors who were intrigued by Enron at $20, WorldCom at $10 and Bear Stearns at $2.

Although money can be made—Bear Stearns was ultimately sold for $10 per share and was thus a good deal for those who bought at $2—most non-professional investors are better off staying away from these situations. The pros who try to take advantage of these opportunities have access to capital and, just as important, information. But even they don't always get it right, as the collapses of Enron, WorldCom and numerous high-profile hedge funds attest.

Here's a general rule of thumb to consider: If a stock is trading below $10, it probably