How to Pick Stocks

The financial pages are commonly full of success stories, stocks that have done well. But, how to pick stocks is not to invest in expensive stocks that have already gone up in price but in inexpensive stocks that are likely to do well in the future. We are talking about intrinsic stock value and the Benjamin Graham formula for deciding if a stock is over price or under-priced. We look at the numbers used to calculate the Graham formula but first of all the basics of **fundamental analysis** of stocks.

How Does a Company Make Its Money?

It is said that the most famous investor in the world, Warren Buffett, likes easy to understand stocks with strong balance sheets. The point of investing is to make money and not lose it. People invest in the stock market because they do not want to settle for the interest rate on a CD at their local bank. However, their CD is insured by federal deposit insurance and the stocks that they buy can just as easily go down instead of up in price. How to pick stocks starts with picking a company that does something that you understand. You do not have to be an expert in computer programming or cellular biology to invest in computer companies or biotech stocks. But you need to have a clear idea of what these companies do to make money, what their costs are and who their competition is. And, you need to look for a margin of safety. This can simply be that the company has a product that totally dominates its field or that they have no debts and money in the bank. The point is that the company is protected in the event of a recession.

Graham Formula

Intrinsic Value (V) = (Earnings per share x (8.5 + 2g) x 4.4) / The current yield of AAA corporate bonds (Y)

Earnings per share are for the last twelve months and g is your estimate of company growth in the next five years. Mr. Graham used 4.4 as a constant for the average yield of high grade bonds at the time he devised the formula. You can adjust this for current yield. This formula gives a stock price, what Graham believed should be the market value. Compare this to the current price. If the Graham price based on fundamental analysis is higher you may wish to buy the stock. If the current stock price is higher than the calculated value you want to sell or avoid the stock.

Finding Stocks

Profitable stocks are often those that are not currently being followed by lots of analysts. Thus they may be hard to find. Start with what you know. A sad but true tale is that in the late

1970s Eli Lilly came out with Tagamet, the first effective medicine for ulcers. At that time the trendy investment for well-heeled physicians was to buy and lease railroad box cars. Lilly stock skyrocketed and many investors lost their shirts in box car leasing scams. If the doctors who were writing prescriptions for Tagamet had invested in what they knew they would have made money. Not every stock is has great possibilities but many are profitable. If you are nearing **retirement** look to stocks that have been paying dividends for decades and, shades of Buffett, are easy to understand with strong balance sheets.