The Revised Foolish 8 Screen: Not-So-Foolish Results

By Wayne A. Thorp, CFA

Historically, small-capitalization companies have outperformed larger companies—even considering the additional risk that smaller companies tend to exhibit.

For this reason, small-cap stocks have long attracted the attention of investors searching for tomorrow's market giant. However, with literally thousands of small caps to choose among, the selection process can be daunting.

Stock screening can help alleviate some of that burden, and the founders of the Motley Fool Web site (www.fool.com) developed a methodology for screening for small stocks.

The original Foolish 8 strategy uses eight criteria to look for profitable and rapidly growing small companies with strong price momentum. The methodology is partly built on the premise that the lack of coverage and interest in small-cap companies presents a better opportunity to locate undiscovered, attractive investment candidates.

A revised version of the screen adds elements of valuation and management effectiveness, and it relaxes the small-cap criteria. This article will discuss the revised Foolish 8 screen.

Foolish Screen Revisions

AAII tracks a screen based on the revised Foolish 8 approach that seeks stocks with:

- Strong recent earnings and sales growth,
- Robust net margin,
- Positive operating and free cash flow,
- Sufficient liquidity,
- Sustained returns on equity,
- Strong price momentum, and
- Attractive valuation based on the relationship between the price-to-free-cash-flow ratio and free cash flow growth.

Stock Investor Pro, AAII's fundamental stock screening and research database, includes the revised Foolish Small Cap 8 approach among its pre-programmed screens (the original Foolish 8 screen is also built into the software).

The specific criteria used for the revised Foolish 8 screen are listed at the end of this article.

Performance: Not-So-Foolish

Figure 1 shows the performance of the revised Foolish 8 screen. Outside of the CAN SLIM screens, the revised Foolish 8 screen is the best-performing growth strategy tracked by AAII. It has generated a positive return in all but one of the years since 1998.

The stocks passing the revised Foolish 8 have been able to outperform the broad market indexes over the last seven years. On an annual basis, the revised Foolish 8 has managed to outperform these indexes in all but two years.

Overall, the revised Foolish 8 screen has easily outperformed the small-, mid-, and large-cap indexes over this 7½-year period, gaining a cumulative 571.5% between January of 1998 and the end of July 2005, compared to a 27.2% increase in the S&P 500. The companies currently passing the revised Foolish 8 screen have outperformed the S&P 500 by

Table 1. Revised Foolish 8 Portfolio Characteristics

Portfolio Characteristics (Median)	Revised Foolish 8	All Exchange-Listed Stocks
Price-earnings ratio (X)	23.3	20.3
Price-to-book-value ratio (X)	5.61	2.24
PFCF-to-FCF growth ratio (X)	0.28	0.27
EPS 5-yr. historical growth rate (%)	25.4	10.0
EPS 3-5 yr. estimated growth rate (%)	20.6	14.4
Market cap. ($ million)	3,761.6	404.0
Relative strength vs. S&P (%)	35.5	3.0
Monthly Observations		
Average no. of passing stocks	8	
Highest no. of passing stocks	19	
Lowest no. of passing stocks	1	
Monthly turnover (%)	31.6	

35.5% over the last 52 weeks, while all exchange-listed stocks have out gained the S&P by 3.0% (Table 1).

Profile of Passing Companies

The characteristics of the stocks passing the revised Foolish 8 screen are presented in Table 1, while Table 2 lists the four companies currently passing the revised Foolish 8 screen (as of August 5, 2005). This small number of passing stocks is half the number of companies the screen has averaged each month since 1998. The revised Foolish 8 screen has had an average monthly turnover rate of 31.6%.

Since the revised Foolish 8 screen seeks smaller companies with high growth rates, it is not surprising that the passing companies have a higher median price-earnings multiple (23.3) than the typical exchange-listed stock (20.3). In addition, their median price-to-book ratio (5.61) is more than twice the median value for exchange-listed stocks (2.24).

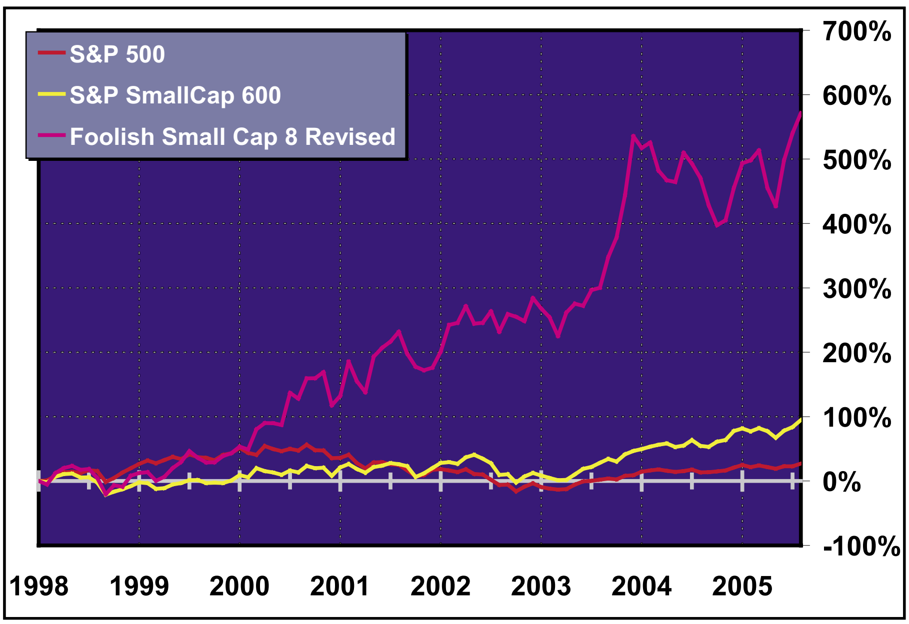
The revised Foolish 8 screen makes use of a PEG-like ratio (price-earnings ratio divided by the growth rate in earnings per share) that relates the earnings growth rate to a valuation measure. It uses the price-to-free-cash-flow rate relative to the free-cash-flow-growth ratio. This ratio is used since earnings are subject to various accounting assumptions (and outright manipulation), whereas free cash flow is more reliable and less apt to be manipulated by management actions and assumptions.

In order to pass the revised Foolish 8 screen, a company must have a price-to-cash-flow-relative-to-free-cash-flow ratio that is less than or equal to 1.0. The median value for the companies passing the revised Foolish 8 screen is 0.28, which is in line with the typical exchange-listed stock, which has a median value of 0.27.

Table 2 ranks the passing companies in ascending order (lowest to highest) based on the price-to-cash-flow-relative-to-free-cash-flow ratio. KOS Pharmaceuticals has the lowest ratio at 0.05.

While the revised Foolish 8 screen requires earnings and sales growth of at least 25% over the last 12 months (trailing four quarters), the companies currently passing the screen also exhibit strong long-term earnings growth. The median five-year earnings growth rate for the revised Foolish 8 screen is 25.4%, compared to 10.0% for all exchange-listed stocks. Looking forward,

Figure 1. Revised Foolish 8 Screen Performance



	Return (%)									Std. Dev.
	1998	1999	2000	2001	2002	2003	2004	YTD*	Cum'l*	(%)
Revised Foolish 8	12.4	36.5	51.5	29.5	22.2	67.8	(3.9)	13.1	571.5	9.2
S&P 500	26.7	19.5	(10.1)	(13.0)	(23.4)	26.4	9.0	1.8	27.2	4.7
S&P MidCap 400	17.7	13.3	16.2	(1.6)	(15.4)	34.0	15.2	8.6	116.1	5.6
S&P SmallCap 600	(2.1)	11.5	11.0	5.7	(15.3)	37.8	21.4	7.2	94.6	5.9
All Exchange-Listed Stocks	5.9	35.1	(14.2)	21.2	(13.3)	81.1	22.8	3.1	195.9	6.8

**Price performance of hypothetical portfolio rescreened and rebalanced monthly using month-end closing prices and no transaction costs.*
Data as of July 29, 2005.

Table 2. Companies Passing the Revised Foolish 8 Screen

	12-Mo. Grth Sales (%)	12-Mo. Grth EPS (%)	PFCF to FCF Grth (X)	ROE (X)	Indus ROE (%)	Daily $ Volume Avg 3 Mo. ($ 000s)	52-Wk Rel Strgth (%)	Description
KOS Pharmaceuticals, Inc. (M: KOSP)	48.2	34.1	0.05	40.7	−35.2	50,967.1	93	specialty pharmac
Center Financial Corp. (M: CLFC)	42.7	54.4	0.08	19.3	12.6	3,513.8	81	bank holding co
Garmin Ltd. (M: GRMN)	33.3	30.5	0.48	24.5	1.1	34,798.3	76	global position sys
Satyam Computer (ADR) (N: SAY)	40.1	34.7	0.51	22.1	4.1	16,617.8	80	info tech servs

Exchange Key: N=New York Stock Exchange, M=NASDAQ National or NASDAQ Small Cap Market.
Source: AAII's Stock Investor Pro*/Reuters Research Inc. Data as of 8/5/2005.*

the companies passing the revised Foolish 8 screen have a higher median estimated earnings growth rate (20.6%) than exchange-listed stocks (14.4%). KOS Pharmaceuticals has outpaced all the other passing companies with its sales growth over the last 12 months of 48.2%. Meanwhile, Center Financial Corporation (CLFC), a bank holding company, has the highest 12-month earnings growth at 54.4%.

Since the Foolish approach to stock screening attempts to identify small(er) companies, the revised Foolish 8 screen requires a company to have revenues over the last four quarters (trailing 12 months) that do not exceed $900 million. Looking at the companies currently passing the revised Foolish 8 screen, the median market capitalization (stock price multiplied by shares outstanding) is $3.8 billion, which is more mid-cap in nature, yet still low, whereas the median market cap for all exchange-traded stocks is $404 million.

Lastly, the revised Foolish 8 screen uses a Warren Buffett approach to return on equity—it looks for strong and consistent return on equity and requires passing companies to have returns on equity of at least 15% over the last four quarters and for each of the last three fiscal years. This restrictive set of filters is why a relatively low number of stocks pass the revised Foolish 8 screen on a monthly basis. KOS Pharmaceuticals, again, leads the way with a 40.7% return on equity over the last 12 months.

Conclusion

No matter how well a stock screening methodology has performed over the long term, it is important to realize that screening is only the first step in the stock selection process. The stocks passing the revised Foolish 8 screen, or any other screen, do not represent a "recommended" or "buy" list of stocks. It is important to perform due diligence to verify the financial strength of the passing companies and to identify those stocks that match your investing constraints. ▲

What It Takes: Revised Foolish 8 Screen Criteria

- Sales for the last four fiscal quarters (12m) is less than or equal to $900 million
- The growth rate in earnings per share from continuing operations over the last four fiscal quarters (12m) is at least 25%
- The growth rate in revenue over the last four fiscal quarters (12m) is at least 25%
- The net profit margin is at least 7%
- Average daily trading volume is at least $1 million
- Insiders own at least 10% of outstanding shares
- The price per share is at least $7
- The relative price strength over the last 52 weeks ranks in the 50th percentile or higher in *Stock Investor Pro*
- Cash from operations for the last four fiscal quarters (12m) is positive
- Free cash flow for the last four fiscal quarters (12m) is positive
- The ratio of price-to-free-cash-flow per share to the growth rate in free cash flow over the last four fiscal quarters (12m) is less than or equal to 1.0
- Return on equity for the last four fiscal quarters (12m) and for each of the last three fiscal years is greater than or equal to 15%
- The company is traded on the New York Stock Exchange, American Stock Exchange, or on the NASDAQ National or Smallcap markets

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