FUNDAMENTAL FINANCIAL ANALYSIS AND EVALUATION OF IBD'S MODEL FOR BUYING AND SELLING COMMON STOCKS

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Introduction

In this research paper, the author uses widely-accepted fundamental principles of finance, which are supported by most of the research evidence, to analyze and evaluate *Investor's Business Daily's* (IBD) model of 20 rules for buying and selling common stocks. The fundamental principles of finance are widely used by most of the successful, long-term value investors and growth investors in the stock market, including Warren Buffet and Peter Lynch.

The IBD model primarily relies on technical analysis, such as charts and graphs of historical movements in stock prices, for short-term, momentum investors who frequently trade stocks. *Investor's Business Daily* newspaper has a large circulation; it publishes the IBD model daily, and uses the model to make stock investment recommendations for its many readers. The IBD model is also aggressively marketed on television and through other advertising media. IBD claims that their model enables stock investors to successfully beat the market, and that failing to use their model will lead to costly investment mistakes. This paper analyzes the IBD model against the principles of finance to evaluate the quality of the model, financially.

My research method in this paper is largely theoretical, in that I use informal statements of a broad set of finance principles to identify important investment criteria missing from the IBD model, and to analyze and evaluate each of the 20 rules used by IBD to make buy and sell recommendations to common stock investors. Some of the finance principles applied in this paper include the principles of

- asset allocation
- portfolio diversification
- the efficient market hypothesis
- buy low and sell high, globally
- equilibrium price
- risk preferences
- financial risks
- risk management
- maximize expected returns
- tax planning
- transactions cost
- financial ratios analysis
- dollar-cost averaging
- value and growth investment strategies

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- forward-looking, rational, self-interest market participants
- market timing vs. time in the market
- stock buybacks and stock splits
- rebalancing
- investor's time horizon
- investment planning
- financial forecasting.

The results of this research highlight some important economic and financial inefficiencies in the IBD model, and recommend ways for both individual and institutional investors to improve their stock market investment decisions and performance. This research paper is also useful for teaching students how to improve their investments in individual common stocks, equity mutual funds, index funds, and/or exchange-traded funds.

The *Investor's Business Daily* (IBD) model for picking stocks is aggressively marketed, with exaggerated claims of providing extraordinary returns to those who would loyally follow the model. According to *Investor's Business Daily Product Guide*, investors following the IBD model would have earned 640.5%, compared to the 21.6% return for the S&P 500, from 1998 through 2004 (O'Neil, 2005). However the actual stocks in the portfolio during historical investment periods are not provided and the claimed historical returns cannot be independently verified.

As this paper will demonstrate, many of the characteristics of the IBD model, including its criteria for selecting common stocks, violate many fundamental principles of finance, and consequently it is most likely that the IBD model has actually underperformed its appropriate stock market index.. These research findings suggest that buying and selling the stocks recommended by the model would be a costly mistake for investors. Per the buyer beware principle of finance, investors need to be careful not to be misled by advertised get-rich-quick investment models that don't make sense, financially.

Given that many stock market investors who account for a significant part of the daily volume of stock trades are making investing mistakes in using the IBD model and other inefficient models in selecting which stocks to buy and sell, many stocks are mispriced; some are overpriced and others underpriced. In addition, with many investors following the same buy and sell recommendations of the same model, in a herdlike fashion, market volatility is substantially increased and trends are extended, such that stocks recommended by the model can see rapid and sustained increases in prices until they are substantially overvalued; while those stocks with sell recommendations can see sharp price declines for extended periods, until they are substantially overvalued. The stock of Google provides an interesting recent example of how momentum investors can substantially drive up the stock price then cause its price to fall precipitously (Delaney and Zuckerman, 2006).

The increased volatility of the stock market, along with the larger and more sustained mispricing of stocks creates too much risk in the market for a high percentage of investors, who respond by either lowering the percentage of their investment portfolio allocated to stocks or get out of the stock market completely, to reduce their potential losses. Bad investors tend to drive good, low-risk investors out of the stock market. With a lower percentage of their investment portfolios allocated to stocks, these lower-risk investors earn a lower return on their portfolios, because of the stock market inefficiencies created by followers of the IBD model and other poorly-designed investment models that violate a number of efficient, fundamental principles of finance. However, the same stock market inefficiencies help raise the investment portfolio returns for a much smaller percentage of high-risk, efficient fundamental investors who can take advantage of the mispricing of stocks by buying low and selling high. Stock market inefficiencies lower the investment portfolio return to most investors, while increasing it for the highest-risk, efficient, fundamental investors.

Fundamental Investment Principles Missing from the IBD Model

The IBD model is likely to underperform its appropriate stock market index, partly because it is missing some of fundamental investment principles of finance that are important to efficiently use in making investment decisions, including common stock investments. These violations of finance principles are likely to mislead investors into making costly investing mistakes.

- The IBD model primarily uses a momentum investment strategy, based largely on technical analysis (Gondo, 2005, p.B1; Hong & Stein, 1999). This violates the efficient market hypothesis, which tells us that technical analysis is not useful for picking stocks that will outperform the market, because stocks are efficiently priced, given all available public information (Gu, 2004; Keown, Martin, Petty, & Scott, 2005, p. 16; Shiller, 2000, p. 199; Tanous, 1997, p. 38). Most fundamental stock investors are value investors, growth investors, and/or aggressive growth investors, based on fundamental financial analysis, using either a bottom-up or top-down approach to picking stocks (Lynch, 1989; Gardner & Gardner, 1997; Vail, 1998; Lowe, 1996; Griffeth, 1995; Domash, 2003; Sheimo, 1999).
- The IBD model encourages short-term investing in common stocks, requiring frequent buying and selling transactions (e.g., day trading). This requirement of frequent trading substantially raises investors' transactions costs (i.e., brokerage fees) and tax liability, partly because the marginal tax rate on short-term stock investments is significantly higher than the marginal tax rate on long-term stock investments for high-income investors for U.S personal income taxes (Adrangi, Chatrath, & Shank, 2002; Choi, 2000). For a given expected return on an investment portfolio, these high transactions costs and high taxes will inefficiently lower the after-tax, after-expense, return on the IBD stock portfolio, relative to its appropriate market index benchmark (Goetzmann & Massa, 2003; Glaser & Weber, 2003). Because of their higher transactions costs, even most professional equity mutual fund managers fail to beat the return on the market index funds they use as appropriate performance benchmarks (Levitt & Dwyer, 2002, p. 55; Rowland, 1998, p. 28; Bogle, 2001, p. x; Baer and Gensler, 2002). It doesn't make sense financially, to violate the principle of least-cost production, by paying more than is necessary to create a given amount of investment income.
- The IBD model lacks an asset allocation guideline, thereby violating the finance principle of optimal portfolio allocation of investments. Finance

researchers have shown that asset allocation decisions determine more than 90% of the return on investment portfolios (Clements, 1998, p. 50). Given that the IBD model lacks an asset allocation guideline, it is likely that investors who follow the model are likely to make the costly mistake of misallocating their mix of stock investments within their larger portfolio mix of different assets. Having a 100% of their investment portfolio allocated to common stocks would be too risky for most individual investors, thereby violating the principle of optimal portfolio allocation (Gitman & Joehnk, 2005, p. 482; Machtig & Behrends, 1997, p. 135). Fundamental investors can also significantly increase their portfolio return, without increasing their portfolio risk, by periodically rebalancing their portfolios (Schwab, 2001, p. 237; Gitman & Joehnk, 2005, p. 479; Clements, 1998, p. 43). IBD investors with unbalanced portfolios are likely to earn less, by failing to rebalance.

- The IBD model lacks a diversification guideline, which is likely to cause IBD investors to be inefficiently too-heavily invested in some growth stocks, in some industries, in some sectors, in some market cap, and/or in some countries. Fundamentally, diversification across many different stocks of companies in different industries and different sectors, with different market caps, including growth stocks and value stocks, in both different developed and developing countries is the best way to reduce stock portfolio risk for most investors (Malkiel, 1998, p. 210; Schneider, 1997; Posner, 1998; Sheimo, 1999).
- IBD investors are also likely to make the mistake of chasing high returns, by aggressively buying more of stocks that have a recent history of high returns, and selling stocks that have a recent history of low returns (Shiller, 2000, p. 198). This violates the fundamental principle that it is best to buy low and sell high (Sheimo, 1999, p. 43). Past performance is a poor predictor of future performance (Levitt & Dwyer, 2002, p. 57).
- The IBD model lacks a minimum investment period guideline to encourage long-term investment, thereby inefficiently encouraging investors to jump in and out of the market, with only short-term investment periods. Short-term investing unduly exposes IBD investors to heavy losses during short-term periods of correction or bear markets. Research shows that long-term buy and hold investors earn a higher average annual return and a higher cumulative return than short-term investors, per the fundamental principle of finance that time in the market beats timing the market (Barber and Odeon, 2000; Bogle, 2001, p. 89; O'Shaughnessy, 1998, p. 145; Vail, 1998, p. 123; Weldon, 1997). By staying in the stock market for an investment period of five years or longer, long-term investors can substantially reduce their risk of incurring a cumulative loss and significantly increase their risk of beating the return on bonds and money market investors. O'Shaughnessy found that for the 1952-1996, investors in the S&P 500 market portfolio of stocks, for every possible five-year period, averaged an annual return of 11.54%, with a loss of 2.35% in the worst period, and a gain of 22.30% in the best period (O'Shaughnessy, 1998, p. 204). Dreman showed that, for all possible 5-year periods from 1946 to 1996, the market return on stocks beat the market return on bonds

84.3% of the time and beat the money market return on U.S. T-bills 82.4% of the time (Dreman, 1998, p. 308). As a finance professor at the Wharton School of the University of Pennsylvania, Jeremy Siegel wrote the classic book, *Stocks for the Long Run*, which documents the fundamental research finding that long-term investors in the stock market have earned a higher cumulative return than investors in any other asset (Siegel, 1998). Earning a higher average annual rate of return on equity investments will make the biggest difference in wealth accumulation for long-term investors who benefit from compounding their returns, per the future value principle, as approximated by the rule of 72, for lump-sum investments, and per the future value of annuity principle for periodic investments (Keown, Martin, Petty, and Scott, 2005, p. 141; Edelman, 2001, p. 61).

- The IBD model inefficiently fails to recommend a dollar-cost average investment strategy. IBD investors lose by selling when the price of stock they own drops by more than 8%, and lose by failing to buy more shares of the stock when it is temporarily undervalued, before the price rebounds to its equilibrium market price. In contrast, investors who use the fundamental financial principle of dollar-cost averaging, by investing a fixed amount of money in stocks periodically, through downturns and upturns in the stock market, average a lower cost per share of stock, and thereby average a higher rate of return on their stock portfolio than earned by other investors (Vail, 1998, p. 125; Edelman, 2001, p. 59; Clements, 1998, p. 34).
- The IBD model advises individuals to invest in stocks on their own, even when these individual investors aren't highly educated in finance, aren't experienced, and don't have much other information for making these important investment decisions. Without the assistance of professional financial advisers, it is likely that many of these IBD stock investors will underperform the market (Belsky & Gilovich, 1999; Rye, 2002). Financially, it makes sense for most investors to hire the experts; their high-quality financial services are worth more than they cost. Most individuals would do better to invest in stocks through professionally managed equity mutual funds given their many competitive advantages in financial markets (Schwab, 2001; p. 133; Rowland, 1998, p. 167; Vail, 1998, p. 131; Glassman & Hassett, 1999).

Technical Stock Selection Criteria Included In The IBD Model That Violate Fundamental Investment Principles of Finance

The IBD model is likely to underperform its appropriate stock market index, partly because some of its technical stock selection criteria included in the IBD model violate some of the fundamental principles of finance that are important to efficiently use in making investment decisions, including common stock investments. These violations of finance principles are likely to mislead investors into making costly investing mistakes. *Investor's Business Daily* instructs investors to carefully follow all 20 rules in its IBD model for buying and selling common stocks to invest successfully (IBD's 20 Rules for Investment Success, 2006, p. B20).

- Rules 1 & 2 advise investors to buy stocks based on the "last three years" of accelerating sales, earnings, and return on equity. While it is useful to consider recent historical financial performance, it is a mistake to only use past performance to predict future financial performance. The IBD model is a momentum model that assumes that recent historical corporate financial trends will continue. However, historical trends don't necessarily continue. actual corporate financial performance often fluctuates significantly from year to year, partly due to changing market conditions in our dynamic global economy. The IBD model predicts the future by looking at the past; it is backward-looking. This violates the fundamental principle that market participants, including investors, are rational, self-interested, and forward-looking. Since investors are primarily concerned with the expected future returns on the stocks they could buy, hold, or sell, it would be better to include some forecasted or projected estimate of future earnings over the next five years, such as the consensus of analysts' estimates of long-term earnings per share. That forward-looking data can be obtained, without charge, by asking for a stock quote at some of the financial websites (e.g., www.quicken.com or www.finance.yahoo.com or www.microsoft.money.com), then clicking on "analysts' estimates".
- Rule 3 instructs investors to "avoid cheap stocks" by buying stocks priced at $15 or more. That rule inefficiently violates the buy low, sell high principle, in not allowing IBD investors to buy some lower-priced stocks that are good investments.
- Rule 4 tells investors to "use charts to see sound bases and exact buy points. Confine buys to these points as stocks break out on big volume increases." Fundamentally, it pays to buy a stock at any price below its equilibrium market price (i.e., for less than it's worth), without regard to its past price movements, and without waiting for its price to shoot higher on big volume trading. Relying on IBD's technical analysis, violates the efficient markets hypothesis.
- Rule 5 instructs IBD investors to "Cut every loss when it's 8% below your cost.... Never average down in price." Following that rule would inefficiently prevent investors from buying low and using dollar-cost averaging to lower their average price per share of stock, in order to increase their average return per dollar invested (Weldon, 1995). In a volatile stock market, stock prices can rise and fall significantly, short-term. Having to sell at 8% below their cost will force investors to lock in losses, and prevent them from benefiting from normal price appreciation to equilibrium market value, after a stock has been oversold by the market.
- Rule 6 requires that IBD investors "Follow selling rules on when to sell and take profit on the way up." Fundamentally, it pays to sell a stock whenever it becomes overvalued (i.e., whenever its market price exceeds its equilibrium market value). It is efficient to sell high. Following IBD's sell rules that assume momentum, based on technical analysis of historical price movements violates the efficient markets hypothesis. IBD's sell rules don't make sense financially. Per the EMH principles, on any given day, there is no

way to know whether the price of a stock will rise or fall; the fact that it has gone up doesn't ensure that it will continue to rise over the next few days or weeks. If the stock is fairly valued, better than expected news will increase its present value and stock price, but new information that is worse than expected will cause its present value and equilibrium market price to fall. From day to day, investors don't know whether tomorrow's news will be better or worse than expected.

* Rule 8 tells IBD investors to "Buy when market indexes are in an uptrend. Reduce investments and raise cash when general market indexes show five days of increased volume distribution." Fundamentally, it pays to buy low, at the bottom of the market. Waiting for five days of price increases on higher volume before buying would inefficiently prevent investors from buying low. Similarly, it is efficient to sell high, when a stock is overvalued. Waiting for five days of price declines on higher volume would inefficiently prevent investors from selling high.
* Rule 8 instructs IBD investors to "Read IBD's Investor's Corner and Big Picture columns to learn how to recognize important tops and bottoms in market indexes." This model incorrectly assumes that the price of a stock will trade within a range between some bottom-price support level and top-price resistance level, and that the price will not fall below the support price nor rise above the resistance price. Fundamentally, in response to new information that changes the equilibrium market value and price of a stock, the market price will adjust quickly to its new equilibrium level, per the efficient markets hypothesis. The new equilibrium price could be outside the historical price range of the recent past, because fundamentally there is no support price, resistance price, nor price range within which a stock can be safely traded.
* Rule 9 requires that IBD investors "Buy stocks with a Composite Rating of 90 or more and a Relative Price Strength Rating of 85 or higher in the IBD Smart Select Corporate Ratings." Those criteria inefficiently increase investors' cost, by requiring them to continue to pay IBD for the use of their proprietary information, including composite ratings and relative price strength ratings. These ratings represent technical analysis for momentum investors. However, neither of these ratings are needed by fundamental investors; since neither provides information about the fundamental value of a stock relative to its current market price.
* Rule 10 tells IBD investors to "Pick companies with management ownership of stock." That rule makes some sense, fundamentally, since agency theory suggests that managers who are also stockholders are likely to more focused on economically adding value to the company and its stock price. Principal-agent problems can be reduced by partly paying managers in the form of stock shares or stock options. However, it is often a mistake to assume that managers who don't own the stock of the company they manage are bad managers. News of insiders buying a stock is not a fundamental reason to buy the stock, because it doesn't change the fundamental value of the stock. Insiders don't necessarily buy a stock only when its undervalued.

- Rule 11 requires IBD investors to "buy mostly in the top six broad industry sectors in IBD's New Highs List." Again, that rule inefficiently raises the cost of buying by requiring investors to use proprietary information provided by IBD. However, it would be better for investors to not use this information, since buying stocks that have recently hit new highs violates the fundamental principle that it is best to buy low. Restricting their stock investment choices to sectors that have recently outperformed the market would also inefficiently cause investors to make the mistake of chasing high returns, and could cause their stock portfolios to become overly concentrated in a few sectors. Fundamentally, it is best to use diversification and rebalancing to maintain an investor's asset allocation strategy for achieving his or her long-term investing goals, at a manageable level of risk, consistent with the investor's risk tolerance level.
- Rule 12 guides IBD investors to "Select stocks with increasing institutional sponsorship in recent quarters." Fundamentally, waiting for a trend increase in institutional ownership before buying a stock would prevent investors from buying low. It would be better to buy before there was a trend increase in institutional ownership. After the institutional investors have bought the stock, it may be overvalued and worth selling.
- Rule 13 tells IBD investors "Current quarterly after-tax profit margins should be improving, near their peak and among the best in the stock's industry." This rule is fundamentally inefficient, in part because increasing after-tax profit margins don't necessarily increase either profits or the value of the stock If stock prices did increase with net profit margins, it would be better to buy the stock before its profit margin increased, rather than after it has peaked. As the discount retailers, like Wal-Mart, have demonstrated, sometimes companies can outperform others in their industry, financially, by accepting a lower profit margin than their competitors require.
- Rule 14 tells IBD investors "Don't buy because of dividends or P-E ratios." Most investors would be better off to ignore that rule. Fundamental value investors prefer stocks that pay dividends, because dividends raise their present discounted value, while lowering their risk (Alltizer & Hamill, 1999). Using the P/E ratio is also one of the best fundamental criteria for value investors, since it tells the investor his cost relative to his current return on a stock (Dreman, 1998; Tanous, 1997). A lower P/E ratio is better, everything else equal. Investors who ignore the P/E ratio could make the costly mistake of buying greatly overvalued stocks. Fundamental financial ratios can be very useful in a stock picking model, but the IBD model fails to efficiently use them.
- Rule 15 instructs IBD investors to "Pick companies with a superior new product or service." Fundamentally, it is better, financially, to invest in companies that have superior products, rather than inferior products, and have new products, rather than old products near the end of their product cycle. However, given that fundamental financial investors and financial markets are forward looking, it would be better to invest in the stocks of companies while they are developing new products that are likely to be superior, rather than

after they have launched and after they have proven their superiority. Waiting to buy a stock until after it has proven its success, would prevent investors from buying low, and may cause them to mistakenly buy high.

- Rule 16 requires IBD investors to "Invest mainly in entrepreneurial New America companies." Following this rule would inefficiently raise the cost of buying, by requiring investors to continue to buy this proprietary information from IBD, to select stocks. However, fundamentally, this information is not needed to identify profitable stock investments. The stocks of newer companies are not necessarily a better buy than the stocks of older companies. Similarly, small companies are not necessarily more entrepreneurial than large companies. To survive and prosper in our highly competitive global markets, all companies neeed to be innovative, growth-oriented, and adjust quickly to changing market conditions. A number of former CEOs have written some very useful and interesting books on how they succeeded, as entrepreneurs, in growing and developing their large, established companies (Gerstner, 2002; Welch & Byrne, 2001; Walton & Huey, 1992).
- Rule 17 instructs IBD investors to "Check into companies buying back 5% to 10% of their stock and those with new management." That seems like bad advice, since any increase in the value of a share of stock created by a stock buyback would already be priced into the stock very quickly after the buyback announcement occurred, per the efficient markets hypothesis. To gain from the announcement, you would have to own the stock before the buyback announcement occurred. Also, it would be unnecessarily risky to prefer the stocks of companies with new managers, unless the particular, high-profile new managers are very likely to be superior to the former managers. While established long-term managers generally have a track record of proven success, financially, it is difficult to know how new, inexperienced managers will affect a company's financial performance. Per the fundamental principle that the quality of management largely determines the quality of a company, a turnover in management is often a better reason to sell the stock than a reason to buy it.
- Rule 18 tells IBD investors "Don't try to bottom guess or buy on the way down." Following that rule would prevent fundamental investors from benefiting from dollar-cost averaging (Weldon, 1995). The stock market has recovered from every correction and from every bear market. Investors who continue to buy during the dips in the market and hold their investments long-term until after the market has recovered and gone to a new high earn a higher cumulative return than those who try to time the market, by trying to sell before it turns down (O'Shaughnessy, 1998, p. 23). Following the IBD rule requires expertise in market timing, which few investors possess. Fundamentally, time in the market is a superior investment strategy to trying to time the market.
- Rule 19 tells IBD investors to "Find out if the market currently favors big-cap or small-cap stocks." Fundamentally, it would be better to diversify your stock portfolio across large-cap, mid-cap, and small-cap companies (Weldon,

1995). Buying only stocks with the market cap that the market has recently favored is unnecessarily risky, and may prevent investors from buying low. The market's preference for some market cap could suddenly and sharply change, unpredictably. In principle, diversifying your stock portfolio across all market caps will usually increase your portfolio return and lower your portfolio risk.

- Rule 20 instructs IBD investors to "Do a post-analysis of all your buys and sells. Post on Charts…." Fundamentally, auditing your investment performance to improve your investment model and future performance is an important part of the investment process. Continuous process improvements are usually an excellent way to incrementally fix problems and improve results in future investment periods. However, as explained throughout this paper, the IBD model is fundamentally flawed. It would be better for most investors to stop using this model, and change to a stock investment model that more efficiently uses the fundamental principles of finance. The phrase "post on charts", in rule 20, highlights that the IBD model is a model for chartists or technical analysts engaged in momentum investing (Darlin, 1994). However, technical analysis and momentum investing violate the efficient markets hypothesis, and are therefore likely to mislead investors into making costly mistakes in buying and selling stocks.

Conclusion

The IBD model is aggressively marketed and widely used by a large group of stock market investors, known as momentum investors, using technical analysis to make buy and sell decisions. Although *Investor's Business Daily* claims that investors who follow their model have and will dramatically beat the market, there is no existing portfolio of stocks whose historical performance can be independently verified. IBD's claims of outperformance are most likely greatly exaggerated.

Per the efficient market hypothesis, it is very difficult to beat the market. The best individual stock investment model would be one that efficiently uses the principles of finance in buying and selling common stocks, given that any inefficiency in the model would likely lower the performance of the model. The IBD model inefficiently fails to include important principles of finance for making stock market investments. It also includes many stock selection criteria that inefficiently violate many important principles of finance. Given these inefficiencies, it is likely that following the IBD model has and will mislead stock investors into making many costly investment mistakes. An important finding of this research paper is that stock investors would be better advised to use a different stock or equity investment model – ideally one that efficiently uses the fundamental principles of finance.

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