Quant Ratings Revealed

“Show me the money!” is not just the mantra for fictional football players. It also works for stock selection. When all subjective factors are set aside and only measurable, objective factors remain, quantitative analysis reveals the companies making money internally and for their shareholders.

That’s why Trifecta Stocks are screened by TheStreet Quant Ratings’ rigorous quantitative stock model before intensive reviews of fundamental analysis by Bryan Ashenberg and technical analysis by Bob Lang.

Most investment advisories focus on just one approach—value investing, say, or swing trading. It is simply too difficult for any single investing guru to examine the thousands of stocks trading on U.S. exchanges with all the tools that are available. But it’s not impossible for TheStreet.

By enlisting two top investing experts with very different styles, and using the award-winning Quant Ratings computer system to the party as well, you get the best of all worlds. Value AND growth. Human insight AND a highly-sophisticated stock screener.

Trifecta Stocks are distinct—they must not only meet the demanding standards of subjective experts but also an emotion-less and coldly rational algorithm. A stock qualifies for membership in this elite club only when it can pass muster with all three of our evaluators. Fail on any of the three’s criteria and a stock is immediately eliminated. Prove merely average in a single test, and we move on to better stocks. And passing all three yardsticks only means a stock has given itself a chance to land on our list. It must still prove superior to all the other outstanding stocks we’re evaluating. Only if it can demonstrate “best of the best” qualities will it be anointed as a Trifecta Stock.

By eliminating stocks that don’t pass all three of the stringent Trifecta Stocks tests, you exponentially increase your potential to outperform the market averages. You will not only own companies that are strong in their business operations, well-managed, handily beating their competition and with rock-solid financials…you will own stocks with top-notch grades when put through Quant Ratings’ algorithms…and with the kind of technical strength that can pay off with astounding short-term gains!

This special report focuses on the aspects of Trifecta Stocks that could only be performed en masse by quantitative analysis. See our other reports for a more in-depth look at technical and fundamental analysis.

The Quantitative Powerhouse

Quant Ratings is TheStreet’s award-winning quantitative and algorithmic stock rating service.

With Quant Ratings, it takes only seconds to know whether to buy, hold or sell any stock you own, and any you’re thinking of owning.

Quant Ratings uses its state-of-the-art algorithmic and quantitative computer model to evaluate over 4,300 stocks every day on 32 different major data factors. Its model sifts through income statements, cash flow
data, balance sheet metrics, valuation, volatility and much more. The result? A single letter grade from A+ to F, derived equally from risk and reward metrics that tells you how much total return potential the stock has for the next 12 months.

Quant Ratings has proven remarkably accurate at identifying both good stocks to own, as well as poor stocks you must sell. For the five-year period ending 12/31/12, owning the S&P500 Index would have given you a total return of 8.5%.

But if you cherry-picked only the best stocks in the S&P 500—those stocks rated a "Buy" by TheStreet Quant Ratings—you total return would have been 14%.

And if you shorted Quant Ratings' "Sell"-rated stocks, you gained 119.2%!

TheStreet Quant Ratings Stock Model – Recommendations and Grades

TheStreet Quant Ratings algorithm is a multi-factor model that uses a purely quantitative approach to stock selection. The stock model objectively assigns ratings to stocks according to their relative “risk-adjusted” total return prospects over a 12 month investment horizon. The ratings reflect both technical and fundamental measures including performance, valuation, and risk factors.

The three recommendations assigned to stocks are simply Buy, Hold, and Sell but these recommendations are broken down further into specific letter grades:

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U.S. Stocks for which insufficient data exists are Unrated. This may result from less than one year of trading history or omissions from quarterly company financial statement filings.

The stock model runs every day that the market is open and processes more than 30 major data factors for over 4,000 stocks. The stock model analyzes data factors for each individual security and assigns an underlying Reward Grade and Risk Grade to each stock. Both the Reward and Risk grade are weighted in specific ways to arrive at an overall rating for the stock.
The basic components of these two grades go as follows:

**Reward Grade Components:**

- **Growth:** Our algorithm looks at growth in Revenues, Cash Flow, and Earnings over multiple time periods.

- **Performance:** Our algorithm measures the historical price movement of the stock and looks at absolute stock performance and performance versus the S&P 500 for various time periods.

- **Efficiency:** Our algorithm measures the strength and historic growth of a company's return on invested capital and return on equity over time.

- **Dividend:** Our algorithm rewards stocks with higher dividends.

- **Valuation:** Our algorithm can be impacted by stocks with a low P/E, low Forward P/E or low Price to Book Ratios.

**Risk Grade Components:**

- **Volatility:** Our algorithm looks at various risk measures such as Beta, Downside Deviation, Drawdown and also Median Gain/Loss to evaluate the potential risk in volatility for a stock. For instance, a stock which has gone from $1 to $100 and back to $2 in a short period of time will be considered risky by the algorithm.

- **Solvency (Financial Strength):** Our algorithm looks at various Balance Sheet measures and ratios such as Debt to Equity, Liquidity Ratios, Bankruptcy Potential. Low Debt and Strong Cash Flow will result in a strong solvency score.

- **Valuation:** Our algorithm can be impacted by stocks with a high P/E, high Forward P/E or high Price to Book Ratios.
Further explanation of the broad algorithm components and how they tie together can best be handled via graphic representation and can be found in Figure 1 that follows:

**Quantitative Performance Grade**

‘Performance’ is a composite measurement of both internal income statement growth and external stock total return. Companies worth owning manage to grow both the top and bottom line on the income statement and translate that into a rising share price.

There are many ways to report earnings-per-share (EPS) that can be influenced by perfectly legal accounting treatments. Earnings may be restated years later to devastating effect. However, dividends paid out to shareholders are real money distributions that are much more difficult to sustain over the long run with creative accounting. So, higher dividends bolster the observed performance.

*TheStreet Quant Ratings* model also considers the historical price movement of the underlying stock over various time periods with a “What have you done for me lately?” emphasis on recent stock performance.

The final kicker to Performance is stock price valuation. Stocks trading at low prices in comparison to the earnings, sales, or book value have room to appreciate.
Quantitative Risk Grade

*TheStreet Quant Ratings* stock model quantifies the risk to be taken by potential investors in three areas: stock price volatility, financial statement strength, and valuation.

Volatility Example:

All 20% returns are not created equal. When deciding between two potential investments that both returned 20% over the last year would you choose the one that bounced around a lot or the one that smoothly rose to the 20% total return?

In this first example, Risky Corp’s share price starts off the year with a crash of 20% on bad chat room whispers amplified by TV commentators just reporting what they heard. The stock spikes upward when Risky Corp denies the rumors. Over the next several months, projections of product revenue are revised lower as competitors rob Risky Corp of market share. After significant levels of insider buying in August and September, the company put itself in-play for a merger in November. Optimistic estimates of the value of Risky Corp’s patents pushed the stock up to $125 a share. Then in December Risky Corp announced the pending acquisition by a larger company for shares in the larger company worth $120 a share.

Quantitative analysis knows nothing of chat room buzz or takeover rumors. However, all available information is already taken into account in the share price.

What quantitative analysis can measure is volatility. The standard deviation of the Risky Corp’s share price is calculated to be 20.8 and the beta is 2.50.
Standard deviation is a statistical measure of the amount of stock price volatility experienced. In absolute terms, standard deviation provides a historical measure of a stock’s deviation from its mean, or average, price over the period.

A high standard deviation indicates a high degree of volatility in the past and implies the potential for a high degree of volatility in the future as well. This translates into higher risk since a large negative swing could easily become a sizable loss in the event you need to liquidate your shares.

Beta is the level of correlation between the stock’s monthly price changes over period being reviewed and the performance of the S&P 500. A beta of 1.00 means that the stock’s price swings have matched those of the index one for one during the stock market’s ups and downs.

A beta of 1.10 means that on average the stock has outperformed the index by 10% during rising markets and underperformed it by 10% during falling markets. Conversely, a beta of 0.85 means that the stock has typically performed 15% worse than the overall market during up markets and 15% better during down markets.

At a beta of 2.50, Risky Corp is showing 150% more volatility than the market, a risky sign.

Near the other end of the hypothetical spectrum is Less Risky Corp. Sure, it dipped in January showing that you can still lose money on lower risk investments but then executed its plan for the year exactly as it boringly laid out in its annual report.

With a standard deviation of 7.5, Less Risky Corp has a low level of volatility. The measured beta of 0.40, means the shares are 60% less volatile than the S&P 500 Index.
Conclusion

Clearly, Less Risky Corp is the superior investment vehicle on the basis of stock price volatility risk and the Quant Ratings algorithm would grade Less Risky Corp higher than Risky Corp. The quantitative review of risk does not end there. Financial statement strength is measured by factors such as debt to equity.

A large level of total debt expressed as a multiple of total capital means the company must spend a large portion of its income on servicing that debt which could become problematic if the company were to experience a drop in revenues. Highly leveraged companies loaded with debt have increased bankruptcy risk.

Lastly, while low price-to-earnings ratios can bolster potential performance, high P/E ratios increase the quantifiable risk that the premium share price multiple may shrink back to a more normal level triggering a decline in the share price at the same level of earnings.

The very top stocks rated at Buy based on the quantitative analysis of TheStreet Quant Ratings have an excellent track record for providing strong performance with minimal risk and trade at a price that represents good value relative to the company’s earnings prospects. While past performance is just an indication – not a guarantee – we believe these stocks are among the most likely to deliver superior performance relative to risk in the future and that’s why our ratings recommendations are the first level of scrutiny for Trifecta Stocks.