

The StockRank™ Style Guide

What Works in the Stock Market

Over the last 100 years, the world's most successful investors and finance professors have formed a broad consensus about which fundamental and technical factors consistently drive stock market returns. The most powerful and well studied are company **Quality**, share **Value** and price **Momentum** which, at Stockopedia, we summarise with the acronym QVM.

QUALITY 

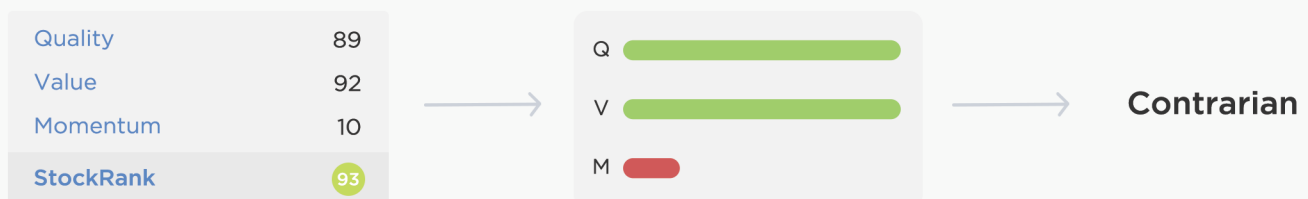
VALUE 

MOMENTUM 

The Stockopedia StockRanks™ take this multi-factor QVM approach and rank every stock for their exposure to each driver. This process helps to simplify the goal of selecting good (quality), cheap (value), improving (momentum) stocks while avoiding the opposite.



But a stock doesn't need to be exposed to all three factors to have a good probability of success. There are actually eight unique combinations of the QVM drivers which create a set of investment archetypes we call the "**StockRank Styles**". Four are winning styles, while four are losing styles. Each bar chart can be related to the StockRanks on Stockopedia StockReports as follows:



The following pages provide a mental model that is exceptionally useful in reading between the lines of the StockRanks. It will help you understand the styles that work best and the common traps to avoid. It shouldn't be complicated to find



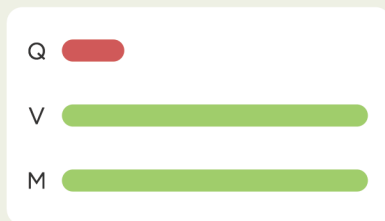
Not every stock will fall into one of our 8 style categories. The majority of shares are style-neutral, which have historically, on average, offered index like performance.

Winning StockRank Styles

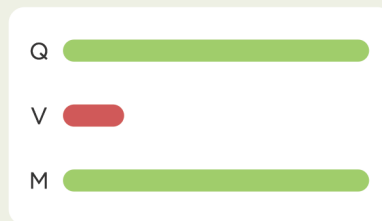
The following four combinations are classic successful investment styles, practiced by some of the greats of investing. They have also posted strong results in Stockopedia's performance studies. A simple rule of thumb is to never consider a share that isn't exposed to at least two of the three QVM drivers.



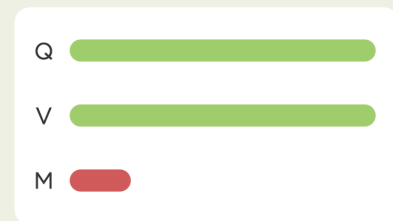
Super Stock



Turnaround



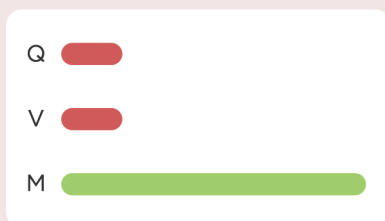
High Flyer



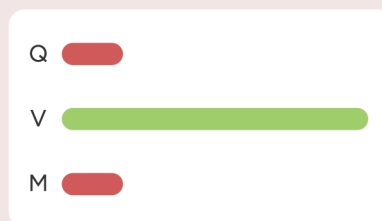
Contrarian

Losing StockRank Styles

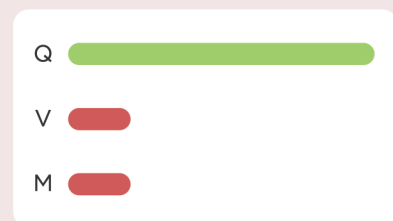
The following four styles are common traps for investors. Shares exposed to only a single QVM driver may be alluring to the novice, but studies have shown average performance to be poor. These kinds of story stocks often come with hopes of jam tomorrow, blue-sky promise or eventual recovery.



Glamour Trap



Value Trap



Falling Star



Sucker Stock

Super Stocks

Quality: High Value: High Momentum: High

Good, Cheap, Improving



Summary

The term **Super Stock** was first used by the late, great Professor Robert Haugen in his book 'The Inefficient Stock Market'. Haugen was one of the first to show that good, cheap, improving shares have a tendency to beat the market. Psychologically it can often go against one's instincts buying these kinds of shares because cheap stocks often have problems, good stocks can be unexciting, and buying stocks at new all time highs is scary. This may be why Super Stocks so often continue to exceed expectations.

Key Quotes

"This is a dream profile, the profile of a stock you would love to own. We shall call this the profile of a Super Stock."



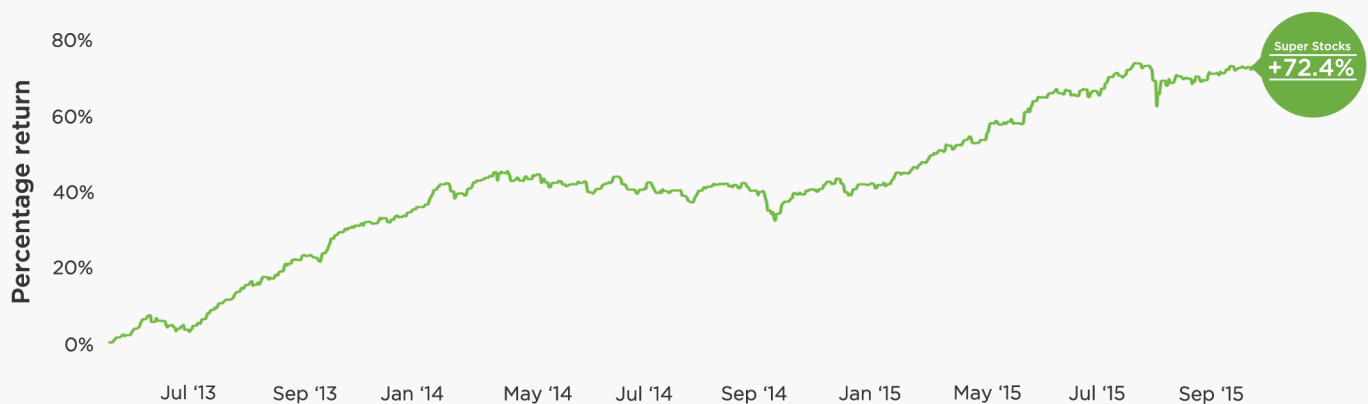
Robert Haugen
US finance academic

"Tilts towards value, momentum and profitability have outperformed the market, and due to diversification benefits, a combined portfolio of these three has provided much higher reward per unit of risk."



Robert Novy-Marx
US finance academic

Results



Based on quarterly rebalanced portfolios of UK stocks greater than £10m capitalisation. Dividends & transaction costs not included.
Past performance is not an indicator of future results.

The Bottom Line

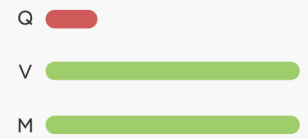
A compelling reason for looking closer at Quality, Value and Momentum is that research shows that stocks with high exposure to these factors are often overlooked. Most investors generally gravitate to stories, popularity and excitement. They ignore shares that appear to be troubled, staid or have seen their prices rise in the recent past. Yet it's this profile of stocks that tends to win in the stock market.

Further reading at: <http://stk.pe/super-stocks>

Turnarounds

Quality: Low **Value:** High **Momentum:** High

Cheap & Improving but Junk



Summary

Cheap, out of favour stocks that are seeing their share prices gather steam we classify as **Turnarounds**. They may not be currently profitable, but they've nonetheless turned the corner to recovery. While they're cheap, analysts may start forecasting an improving outlook ahead of the news, ratcheting up their earnings predictions and kicking off a new share price trend.

Key Quotes

“A combination of value and momentum strategies, a tactic we call ‘Trending Value’, is the best performing strategy since 1963.”



James O'Shaughnessy

CEO of O'Shaughnessy Asset Management

“One of the key attributes of momentum is not just that it works, but that it's negatively related to value. When you combine these two things, it just makes your overall portfolio so much better.”



Toby Moskowitz

Principal, AQR Capital Management

60.00%

Results



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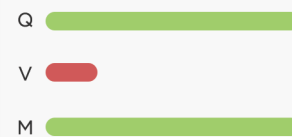
It's undeniable that in the absence of business and financial quality, investing in Turnarounds can be risky and unpalatable. Investing in Turnarounds means digging around among cheap shares that may have suffered major upsets and face unpredictable futures. But when they work successfully, they can reward investors with sudden and spectacular gains.

Further reading at: <http://stk.pe/turn-arounds>

High Flyers

Quality: High **Value:** Low **Momentum:** High

Good & Improving but Expensive



Summary

High Flyers are the stock market stars that every investor wants to own. They tend to be very high quality growth stocks with a history of beating expectations, but success brings soaring prices and expensive valuations. US legend William J. O’Neil, spent years analysing the factors that drove the greatest stock market winners in history. His conclusion was that traditional measures of value missed them, and that momentum was far more powerful.

Key Quotes

“It seldom pays to invest in laggard stocks, even if they look tantalizingly cheap. Look for, and confine your purchases to, market leaders.”



William J. O’Neil

Author, Stock broker and Publisher

“One market paradigm that I take exception to is: Buy low and sell high. I believe that far more money is made buying high and selling at even higher prices.”



Richard Driehaus

Chairman & CEO, Driehaus Capital Management

Results



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The Bottom Line

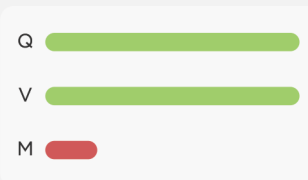
High Flyers tend to be volatile because they have high price momentum and can suffer stronger reversals than the overall market. But it is only amongst this category of stocks that investors can find the great multi-year, wealth generating compounders.

Further reading at: <http://stk.pe/high-flyer>

Contrarians

Quality: High Value: High Momentum: Low

Good & Cheap but Declining



Summary

Buying quality stocks selling at cheap prices is the **Contrarian style**. Contrarian stocks tend to have a track record of profitability, earnings stability and financial strength, but they may be in out-of-favour sectors, or suffering some sort of operational issue. As a result they can suffer from flagging share prices which may provide an opportunity to those that see a brighter future ahead.

Key Quotes

“Whether we’re talking about socks or stocks, I like buying quality merchandise when it is marked down.”



Warren Buffett

Chairman & CEO, Berkshire Hathaway

“Buying good businesses at bargain prices is the secret to making lots of money.”



Joel Greenblatt

Fund Manager, Gotham Funds

Results



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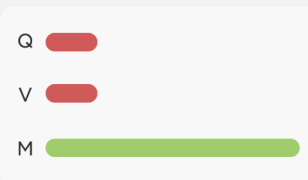
The Bottom Line

Combining quality and value may help to find diamonds in the rough at the very cheapest end of the market. It echoes the quality-driven philosophies of some of the very best fund managers who insist on buying quality, but resist paying too much for it.

Momentum Traps

Quality: Low Value: Low Momentum: High

Improving but Expensive & Junk



Summary

Stories in the stock market are like a magnet to investors and can generate high share price momentum when the herd starts to believe. Yet a good proportion of these stocks run at losses and boast very stretched valuations. These glamour stocks are at high risk of becoming **Momentum Traps** - where a sudden change in sentiment over future potential can see their prices crash.

Key Quotes

“You’ll get nowhere buying stocks just because they have a great story. They often have sky-high price-to-earnings, price-to-book, and price-to-sales ratios. They’re very appealing in the short term, but they’re deadly over the long haul.”



James O'Shaughnessy

CEO of O'Shaughnessy Asset Management

“Of all the dangers that investors face, perhaps none is more seductive than the siren song of stories. Stories essentially govern the way we think. We will abandon evidence in favour of a good story.”



James Montier

Asset Allocation team, GMO

Results



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The Bottom Line

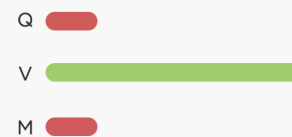
Momentum is one of the strongest drivers of returns in the stock market and can carry shares a long way, but it has to eventually be backed up by cashflow. To avoid the risk of succumbing to a momentum crash, investors should ensure that stocks they buy are either profitable or at moderate valuations.

Further reading at: <http://stk.pe/momentum-traps>

Value Traps

Quality: Low Value: High Momentum: Low

Cheap but Junk & Declining



Summary

In the hunt for mispriced, undervalued stocks, value investors have to look in the deepest, darkest corners of the market. It's here that unloved, broken and misunderstood companies languish. Some will go on to recover, delivering the spectacular returns that have made value one of the core drivers of market returns. But lurking among them are the **Value Traps** - stricken stocks that may either never bounce back or make you bear too much opportunity cost to make it worth the wait.

Key Quotes

“Just because a stock is cheap doesn't guarantee that it brings with it value. Penny stocks derive their name from their low price, but they often prove a trap for the inexperienced investor.”



Richard Tortoriello

S&P Analyst & Author of Quantitative Strategies for Achieving Alpha

“The possibility of sustained decreases in business value is a dagger at the heart of value investing.”



Seth Klarman

Billionaire founder of the Baupost Group & Author of Margin of Safety

Results



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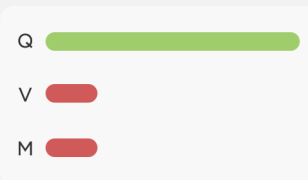
Everyone loves a bargain, but too much focus on buying 'cheap' without considering company quality or potential for recovery can risk disappointment. At best it can lead to the prolonged agony of waiting for value to 'out' - if it ever does.

Further reading at: <http://stk.pe/value-traps>

Falling Stars

Quality: High **Value:** Low **Momentum:** Low

Good but Expensive & Declining



Summary

When a High Flyer starts to lose momentum, it can become a **Falling Star**. Analysts cutting estimates and downgrading the stock may be one of the early warning signs of trouble, and missed numbers lead to falling share prices. Falling Stars may be good quality businesses suffering only temporary declines, but if the decline becomes severe it can make any sort of recovery more difficult and protracted.

Key Quotes

“If a company’s story changes for the worse to a material extent, I immediately sell. Speed is of the essence - you want to be first in the queue of disappointed enthusiasts.”



Jim Slater

Investor & Author of The Zulu Principle

“Expose your portfolio to the best stocks the market has to offer and cut your losses very quickly when you’re wrong. That one sentence essentially describes my strategy.”



Mark Minervini

US investing champion & Author of Trade Like a Stock Market Wizard

Results



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The Bottom Line

The stock market is littered with examples of market darlings with share prices that were stretched, snapped and never recovered. Having shattered the confidence of investors, they can spend long periods in the doldrums and the opportunity cost of holding on may well be too great to bear. The risk of catching a falling knife may well make these shares untouchable.

Further reading at: <http://stk.pe/fall-stars>

Sucker Stocks

Quality: Low Value: Low Momentum: Low

Expensive, Declining, Junk

Q 

V 

M 

Summary

Sucker Stocks typically they operate in highly speculative sectors such as oil and mining exploration, blue sky technology or biotechnology and have very little exposure to the quality, value or momentum payoffs. Research by Robert Haugen, a groundbreaking financial academic, isolated the traits of what he called ‘stupid stocks’ as being: “relatively small, and illiquid, risky, financially shaky, negative momentum, unprofitable now and getting worse, yet selling at high prices relative to current sales, cash flow, and earnings”.

Key Quotes

“Focusing on the cold hard facts (soundly based in real numbers) is likely to be the best defence against the siren song of stories.”



James Montier

Asset Allocation team, GMO

“It turns out that people simply aren’t very good statistical information processors, and that this deficiency leads them to make consistent and predictable investment errors.”



David Dreman

Founder & Chairman, Dreman Value Management

Results



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The Bottom Line

Nearly every sucker stock has an exciting story that will apparently lead it to redemption, but humans are blinded to the facts by the allure of a good story. The facts are plain. Just as with lottery tickets, the occasional sucker stock will do well but the majority are likely to dramatically underperform.

Further reading at: <http://stk.pe/sucker-stocks>

One stock's journey through the StockRank styles

Over time, changes in share prices, broker sentiment and company fundamentals can lead stocks to journey between the StockRank styles.

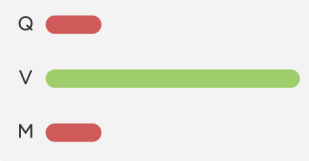
Let's take a look at a case study below...



Barratt Developments

July 2008

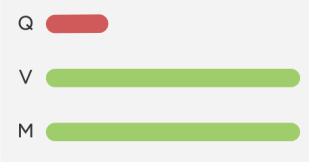
In the aftermath of the financial crisis, housebuilders were pummelled by the stock market and Barratt was no exception. Its share price had fallen by 95% leaving it deep in bargain territory and only the bravest value investors dared touch it.



Value Trap

January 2012

Barratt's share price started to catch a tailwind ahead of an upswing in broker expectations. Debt had begun to fall and a return to profitability looked more probable.



Turnaround

January 2014

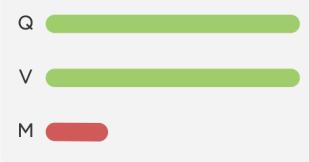
The stars aligned as Barratt's momentum accelerated on impressive improvements in its financial results, with soaring profits, rising margins and strong returns on capital. The shares continued to look reasonably priced and its StockRank hit 90 for the first time.



Super Stock

January 2016

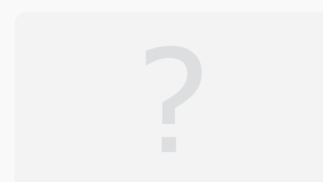
After a very strong multi-year run Barratt's share price reversed on concerns over interest rates, Brexit and government policy. The fall offered an opportunity for brave contrarians to purchase what was a very profitable, quality stock at a more reasonable valuation.



Contrarian

What next?

If the contrarians are proven right, the stock will regather momentum and return to Super Stock status. But housebuilders are cyclical and Barratt has history... could this lead it into a style-agnostic purgatory... or worse back to Value Trap status?





Get Ready. Set. Go!

1. Which investor originally came up with the term “Super Stock”?

- Robert Haugen Warren Buffett James O’Shaughnessy Peter Lynch

2. Which style of stock is this? **Quality**: High **Value**: High **Momentum**: Low

- High Flyer Sucker Stock Contrarian Value Trap

3. Which two of the following factors would a Turnaround most be exposed to?

- Quality Value Momentum Size

4. If a stock is good, improving but expensive, what style would it be?

- Momentum Trap High Flyer Turnaround Sucker Stock

5. If a stock has a high Value, low Quality and low Momentum what style is it?

- Contrarian Value Trap Super Stock Falling Star

6. What is the most attractive attribute of a Sucker Stock?

- Its Quality Its Value Its Momentum Its Story

7. Which of the following are common psychological barriers to investing in Super Stocks?

- Going against the herd Buying at new highs Tolerating boredom Comfort with discomfort

8. Which style of stock is this? **Quality**: Low **Value**: Low **Momentum**: High

- High Flyer Value Trap Momentum Trap Sucker Stock

