This Week's Wizard: Jordan Kimmel

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Buy High and Buy Healthy

Q&A with Jordan Kimmel, Magnet Investing Report

What's your view of the stock market?

The market right now is one of the strongest markets we've seen in a long time. The most remarkable thing about it is that all this positive tape action is taking place with a backdrop of only negative news. We're looking at the President at a low approval rating. We're looking at international concerns, as well as the 15th interest rate increase. And yet what we're seeing is an advance-decline line that continues to ratchet higher, and a new low list that remains muted even during sell-offs. This is a market in which the S&P 600, the Russell 2000 and the NYSE Composite unweighted indexes are all trading at all-time highs.

So, it's an impressive market, and just as interesting the market is now being led by some growth sectors again as opposed to only being led by energy and basic materials several months ago.

What sectors are these and what does that mean?

You're looking at groups like telecom, fiber optics, networking, semiconductor manufacturing, and, something we've talked about for a while now, the gaming group, which seems to be getting stronger and stronger. These are growth sectors. People have always been weary of a market led by cyclical stocks, which tends to signal the end of a bull market. This is a very healthy environment that's really waking the growth market up again, and slowly but surely people are realizing the market is doing better and they need to look around and figure out where to put some money.

How do you determine where to put your money?

We invest based on our quantitative model, called the Magnet Stock Selection Process. We realize that earnings are probably one of the least important things to look at, and that's still what Wall Street focuses on. When we want to find a growth company, we want to look first at topline revenue growth. We want to couple that with margin acceleration and accelerating cash flow to the bottom line. That's the growth side. We also want to make sure we're not paying up for anything, so we want to look for companies with low price-to-sales within their own industry. We look at companies with very little debt and we want companies that also trade at a significant discount to their valuation, so that the growth side and the value side are covered.

Then what we do is use the market itself to confirm our selection process. Which means if we're going to short a stock it has to be going down, and if we're buying a stock long in the portfolio that stock still has to be in a long-term uptrend. So we want to see the market confirming our analysis. We blend all three together. Not a lot of companies will rank up high on all characteristics. The ones that do we call Magnets and they attract other capital from other investors.

We noticed that two of the three companies you added to your newsletter's model portfolio this month -- Valero Energy (VLO) and Giant Industries (GI) -- are in energy. Is that industry scoring high in your model in terms of value, growth and momentum?

Yes, and there's one more aspect to this group -- everyone thinks they should roll over! Everyone keeps saying that oil has been a technical blip and it's been more involved with a potential supply cut-off, or some sort of terrorist premium. The reality is it's very much supply and demand driven, it's not a short-term phenomenon. In fact, most people I speak to are waiting for these things to roll over -- they don't trust them. So, one other aspect here is that this sector is not being bought in a frenzy. People are adding to these things reluctantly, but when they rank up as high as they do in our model, we continue to buy this sector and the names that rank highest within it.

We also noticed that eight of the 20 names in your portfolio are in technology.

That's what's scoring out the highest for us. We also see that a lot for names in technology are in the small- and mid-cap area. We're only seeing a couple large-cap tech stocks that rank high to us. A lot of people look at certain companies like Microsoft (MSFT), Sun (SUNW), and Intel (INTC) and they say technology is dead. They forget that when tech was making the big moves in the early '80s, these companies were very small themselves. So it's very important to be willing to look not necessarily at the names you're comfortable with, but really be open-minded and ask yourself: Who is generating the combination of all the factors we look at? In particular, revenue and margin growth coupled make a powerful growth company.

It's interesting that small caps after a long run continue to rank high.

This is another area that amuses me. The reason everyone looks for the large caps to take over leadership is that they simply haven't done well. That's a real bad reason to invest in something. The reality is some of the larger companies that do rank up for us happen to be in the energy area, and we're not against large companies, we're just against slow growth or companies that have reached their peak already.

So you mean "buy high and sell higher"?

It's not so much a momentum strategy. Rather, it's buy healthy. Clearly companies that are healthy and receiving some market recognition take on the trait of momentum. We're careful not to be labeled as momentum players. On the other hand, there's been too many studies done that will show you that relative strength does significantly add to portfolio return, as long as you also use a combination of value factors that we look for and make sure you're not buying just because something is going up. We're buying because the fundamentals are there, but we love an uptrend to jump on board as well.

We see 4-5 stocks of the 20 in your model portfolio up +40% since you began your newsletter in early October and a good 8-9 in double digits. So clearly it's been a strong strategy. We do have to ask you about one outlier, however -- Standard Microsystems (SMSC) -- down about 20%. Do you have a strategy for stocks at that level of decline?

Very important question. What we've said in our newsletter and the way we manage money is that when a stock is down 20% it actually sends shivers around here. We put that stock on what we will call probation. It's not a hair-trigger, knee-jerk reaction to 20%. It's another careful analysis. At that stage we will never average down in a stock. We will watch its behavior. Does it rally on light volume? Does it sell off again on high volume? If that's the case, the stock fails its probationary period. In our monthly newsletter we only bring in new names at the first of the month, and Standard was brought in at a drop overbought condition. It still remains in a very healthy uptrend, above a point-and-figure support line, and in fact it's at a great position to buy the stock if you haven't bought it now.

Too much money has been lost in this market averaging into positions that haven't worked, explaining away companies, and that leads to emotions and also leads to disappointment. I'm going to guess that Standard Micro will pass its probation, and by the time the next newsletter comes out I would expect that stock to have already strongly recovered. If it hasn't you'll see us simply, unemotionally move on.

Any parting shots?

Getting the market right first and the sector right second are two of the main aspects of our strategy. I'm very committed to then drilling further and finding the Magnet stock within the sector. When you get all three of those things right, and couple that with unemotional, proper portfolio management, I think you'd be able to duplicate what we're doing in our list.

Jordan Kimmel is Author of the Magnet Investing Report and Managing Member and Portfolio Manager with Magnet Investment Group and Market Strategist for National Securities Corporation, one of the oldest and largest independent brokerage firms in the country. Magnet Management accounts and employees have holdings in VLO, GI and SMSC. ***Click here for more of his recommendations and analysis, and to learn more about Magnet Investing.***