



Whether you're a seasoned pro or new to the world of investing, playing the stock market is not for the faint-of-heart. So before you begin, it's useful to have an understanding of the types of companies and stocks you can invest in and the different approaches and techniques that can be used in the selection process. The approach you use should reflect your investment needs and should help you to achieve your long-term financial goals.

The "growth" approach to stock selection is one of many approaches that investors can use to evaluate a stock. The growth approach seeks to evaluate a company's future earnings prospects. The belief is that what drives a company's stock price is how much money the company earns. As with any other approach to selecting stock, there are various opinions as to what constitutes a high level of growth.

When using this approach to select stocks, the following measures are important to know:

Earnings Momentum

Earnings momentum is a relative measure of the rate of change in the growth of earnings. For example, if a company is anticipating a 25% growth in earnings in the next year, that might sound impressive. Yet if earnings in the previous two years grew at 45% and 35% respectively, the 25% doesn't look quite that good.

On the other hand, a company whose earnings have been growing consistently at 8% per year, and whose earnings are expected to grow at least 15% for the next three years due to a new product, could be an excellent growth stock. The important thing to remember here is that the key to earnings momentum is the change in the rate of growth in earnings.

Price-to-Earnings Ratios

As a growth-approach investor, you may also be interested in looking at a stock's price-to-earnings or P/E ratio. While value investors would look at the low P/E ratio relative to the norm, growth investors would look at the P/E relative to the anticipated earnings growth rate. If the market is pricing a stock at 12 times earnings and a five-year growth rate of 20% is anticipated, the stock may represent a growth opportunity.

Price-to-Sales Ratios

The idea behind this ratio is that earnings per share can be affected by non-cash items such as depreciation, etc., but revenues represent real earnings. A growing level of sales revenues is important to growth investors. Price-to-sales ratios are relative to industry groups. For example, a grocery store would be expected to have a different price-to-sales ratio than a defense contractor.

To calculate the price-to-sales ratio, divide the price of the stock by the sales, or revenue, per share of the company.

Non-Financial Attributes

When looking for companies with good long-term growth prospects, it's important to look at numerous non-financial factors, such as new products, new markets, new technologies, quality of management, ability to increase market share, etc.



Investment Themes

As a growth investor, you might look for companies that are positioned to take advantage of areas of concern or need that will grow in the future. Examples include: the aging of the population and its implications for the future of healthcare; the ever-growing concern for the environment; or the state of the country's infrastructure. There are many themes that will arise and change in importance over the years. These changes can be sources of opportunity for growth investors.

By including growth stocks in your portfolio - in addition to other types and styles of investments - you are ensuring it's well diversified and that you're not "putting all your investment eggs in one basket."

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