DOW THEORY FORECASTS

Four tips on using Quadrix

By Rich Moroney, Editor, *Dow Theory Forecasts*

I designed the Quadrix® Overall score to measure all U.S.-traded stocks with a single yardstick, and the metric has performed that task admirably. Since its introduction in 2000, the Overall score has compiled a good record of picking the right sectors and groups — and the right stocks within sectors and groups.

Still, the Overall score's growth-at-a-good-price approach works better in some market segments than in others. That's one reason we created sector-specific scores, which measure stocks relative to sector peers based on metrics that work especially well in a certain sector. But even our sector scores can't account for all the factors likely to drive returns, so we've developed some guidelines on the best way to use our scoring system.

• **Be wary of wacky data.** We've built redundancy and diversity into Quadrix, so it is less likely to be misled by an unusual event, like a huge restructuring charge or one-time gain. But sometimes such items impact several valuation or growth measures, rewarding or penalizing a stock unduly.

• **Be wary of groups that always trade at rock-bottom valuations.** Because reinsurance stocks are nearly always cheap, and because reinsurers have up-and-down growth rates, some stocks in the group nearly always earn very high Overall scores. You may not want to always dismiss such perennially cheap groups, but a high Overall score has not been an effective buying signal in such groups as electronic components, reinsurance, technology distributors, and textiles.

• **Be wary of cyclical stocks in the late stages of an industry expansion.** Cyclical companies tend to have good operating momentum in the late stages of an industry upturn. That is when valuations tend to be modest, since investors are reluctant to pay high price/earnings ratios when earnings may be at a cyclical peak.

We have made money betting on such names; late-cycle stocks are called that because they perform well late in the cycle. But with cyclical stocks we pay extra attention to the likely duration of an industry expansion — and to a company's ability to surpass consensus profit expectations.

• **Don't be afraid to have a good chunk of your portfolio in a few high-scoring sectors — especially if the sectors are big and Quadrix works well in them.**

Conclusion

Diversification is the one free lunch on Wall Street, and you never want a single sector to dominate your portfolio. But don't let your desire for diversity lead you into second-tier names, and don't focus excessively on sector labels. Our buy lists have delivered market-beating returns with below-average risk since 2000, even though we have often overweighted a few sectors.