CompareShares.com.au
Your net advantage

Taking stock

How to set up a stock watchlist

Mark Story - August 11, 2008

Shadow-boxing the sharemarket through a 'phantom portfolio' is one way to track stocks you might fancy. But Alex Henderson, investment analyst with Sage Private Clients says investors who bother to set-up stock watchlists should gain the discipline and confidence to either piddle or get off the pot.

Assuming they're set up properly, he says sector-specific watchlists let investors build a valid case for why they might choose to buy or sell certain stocks. "Establishing stock watchlists on a sector-by-sector basis allows you to compare apples with apples," says Henderson. "But beware of trying to fully analyse too many stocks on a regular basis, between 20 and 30 is usually a recommended amount."

According to Elio D'Amato CEO with boutique fund manager, Lincoln Indicators stock watchlists should be only one component of a broader watchlist diary trail. Within that diary, he says investors need to state the reasons why they would either buy or sell the stocks they're currently watching. "Savvy investors should use their watchlist diary to map-out their equity choices before they commit their hard-earned cash," says D'Amato.

He warns investors not to add stocks to their watchlist unless they're committed to doing just that – regularly watching them. "In addition to media coverage, make sure you regularly read all company announcements and go over the company's full and half year financials," advises D'Amato.

So what sorts of stocks are worth adding to a watchlist? While Henderson advocates diversified stock watchlists, he says there will be times, (as within today's resources boom) when market conditions warrant over-exposure to single sector. He says stocks that typically move the market up or down – like BHP which accounts for over 10% of the S&P/ASX 200, are usually a good window on the fortunes of other stocks within the sector.

Henderson says it's these heavyweights that allow investors to get an early insight into prevailing trend-drivers and what themes might be moving the overall market. "Recent share price falls in Industrial property group, Goodman (GMG) are likely to impact investor sentiment towards other listed property trusts," says Henderson. In addition to these 'weather-prophet' stocks, Henderson says watchlists should also straddle stocks with strong fundamentals, speculative smaller-caps, plus some contrarian plays where the share price has already factored-in bad news.

He says stock watchlists work best for more active, as opposed to passive investors who know what they expect from certain stocks – income or capital growth, and over what time horizons. "It's important to look beyond short-term negative market sentiment which tends to throw fundamentals out the window," advises Henderson. "Looking to the strength of your long-term positions (on favoured stocks with strong fundamentals) allows you to get paid for your patience over time."

He cites the market's one-time 'beat-up feast' on Telstra over T3 as a case in point. Given that Telstra provided a guaranteed yield of 14%, while margin lending rates at the time were around 7%, Henderson says looking beyond the negative market sentiment made buying more stock a sound investment. Negative market sentiment dished-out to Wesfarmers provides a more recent example.

Mid June saw Henderson increase the company's portfolio position on Wesfarmers following management revelations a turnaround would take longer than expected. When negative market sentiment drove the share price down 20% within two days (to $32.50) Henderson knew it was time to buy more stock. "The company's announcement fitted within our long-term position (on Wesfarmers) and share price weakness complemented our yield strategy on the stock."

So when should a stock be removed from a watchlist? The two most obvious reasons according to D'Amato are when the company's fundamentals change or the reasons why a stock was initially put on a watchlist are no longer valid.

So when it comes to narrowing down the list of choices, D'Amato recommends investors start by scrutinizing a company's vital signs (its fundamentals), together with any structural changes within the sector the company operates in - plus any changes to their own risk profile.

While the share price is less relevant if the fundamentals are in place, he says nobody wants to get into stocks that are falling or that have been driven down further than other stocks within the same sector. "Current share price weakness could be a good time to accumulate stocks that have been beaten up more than they deserve, but the fundamentals must be intact," he adds.

When it comes to eyeballing key fundamentals into a stock's fortunes, he recommends investors keep a close watch on the strength of underlying earnings, debt-to-equity ratios, and the P:E ratio relative to valuations. Key financials include earnings per share (EPS), and within current market conditions, D'Amato says investors should be looking for between 8% and 12% growth. "Equally revealing are the company's return-on-assets - a key indicator of asset efficiency, and its PEG ratio which compares P:E to EPS growth," says D'Amato. "And if having compared apples with apples you still can't decide between two or three stocks, it might pay to take a smaller holding in each of them."

END