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# How to Pick Winning Retail Stocks, Pt. 1

*Digging deep into the fundamentals is key to unearthing investable companies.*

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**BY WAYNE BURRITT**

Jun 8, 2007 4:28 PM EDT

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*This column was originally published on RealMoney on June 1, 2007 at 10:00 a.m. ET. It's being republished as a bonus for TheStreet.com University readers. For more information about subscribing to RealMoney, please click [here](#).*

I've been following retail stocks for my regular column on *RealMoney* since November. I'm happy to say that out of the 19 companies I've written about, 17 are in positive territory. Leading the way are:

- **Dollar General (DG)** ( December 2006 ) with a rise of 37% since I wrote about it;
- **GameStop (GME)** ( January ), up 36%;
- **Polo Ralph Lauren (RL)** (also December 2006 ), gaining 17%; and
- **Yum! Brands (YUM)** ( February ), plus 16%.

Meanwhile, the **S&P 500** is up 10% and the **Retail HOLDRs ( RTH)** -- a good proxy for the retail sector -- is up 7.1% since last November.

Of course, not all the picks have worked out. We stopped following January pick **Circuit City ( CC)** after it continued to disappoint. And I'm still waiting for **American Eagle Outfitters ( AEO)**, which I wrote about in November 2006 , to come around.

Still, on average, things have worked out nicely. I thought it would be worthwhile to take you on a backstage tour and show you my process for picking out a retailer that looks poised for a move up.

## **Shop What You Know**

One of the best ways to begin picking retail stocks is to begin studying retailers that you are familiar with. After all, as shoppers we're some of the best judges of the retail experience, having developed a pretty keen sense of what works and what doesn't.

That means you have to figure out what kind of retailers you might know something about -- apparel? sporting goods? electronics? It's a good idea to have a list of a half-dozen or so potential companies because they won't all make the final cut.

I'll discuss apparel retailers in the next section because I'm interested in them. But if you've read my column before, you know that my interest in retailers is wide and varied. In fact, I like just about any retail platform, from department stores to home improvement to restaurants.

I encourage you to follow suit. Search your interests and find the retailers that excite you and sell products you know something about.

## **Hit the Pavement**

Then comes the fun part: making a trip to those retailers. Depending on the type of retailer I'm researching, I look for different factors at each. And chances are I'll visit as many locations as I can.

For example, at a department store such as **Kohl's (KSS)**, **Dillard's (DDS)** or one of **Federated's (FD)** brands such as Macy's or Bloomingdale's, I want to see a wide selection of merchandise at reasonable prices. I'm not expecting a ton of service, which frankly suits me fine; I want to go in, grab what I need, not wait too long to buy it and get out again. That also means the apparel and accessories have to be well organized, easy to find and well stocked, no matter what time of day it is.

When I visit, I'm paying close attention to whether the company is paying close attention to these factors. That of course assumes that my personal shopping habits aren't too idiosyncratic to be generalized to the bulk of the consumer audience, but I'm assuming here that you're going to think critically about the research you do.

At a specialty apparel retailer, such as **Men's Wearhouse ( MW)**, I'm judging slightly different aspects of the business. For example, if I'm looking for a suit, dress shirts or tailored slacks, I want attentive and courteous service. Even after all these years of looking at clothes, I still need a salesperson to help me pick out the right suit. Plus, my new clothes will need to be tailored and pressed before I can take them home.

Because I need the services, I'm willing to pay the higher price points. One thing I particularly admire about Men's Wearhouse is that it leverages this for higher sales; salespeople always make the pitch for a whole new ensemble when I came in for a simple shirt or pants. This shows focus and drive, two big pluses when you're looking for service. I also like to see stores that are bustling with buyers, a tried-and-true signal of solid retailing prowess.

## **Make Sure It's for Sale**

So far so good: You've made a list of the retailers you know something about and think are top-notch. But before you go any further, you have to make sure the companies on your list are publicly traded.

That's easy enough. Use your favorite search engine to find the retailer's Web site. Once there, look for an Investor Relations link -- you'll probably see one if it's publicly traded, and that section should include the ticker symbol along with plenty of other useful information for prospective investors.

Failing that, check out the About Us section. The store you enjoy shopping in may be held by a larger entity. For instance, Bath & Body Works is a popular shop, but it isn't publicly traded. However, parent company **Limited Brands ( LTD)**, which is named in the About Us section of B&BW's Web site, is.

Or, you may want to start with your favorite stock site, such as *RealMoney*, and look up the name of your retailer in the quote feature. (On *RealMoney*, use the "Get a

Quote" box in the upper right corner of any page.) If it's publicly traded, it should show up in the list of search results. If it doesn't come up, you may need to do a little more research, as I described above.

If you find your retailer just isn't publicly traded, cross it off your list and go on to the next potential winner.

## **Narrow Your Shopping List**

Once you've identified the retailers you like and figured out the publicly traded entities behind them, it's time to narrow that list with a stock screener or filter.

A stock filter takes a long list of stocks and narrows them down by particular criteria. Those criteria can be fundamental in nature, such as price-to-earnings ratios or revenue growth rates. They can be technical, such as stocks hitting 52-week highs. Or they can be a combination, which is what I like to use.

Filters are available several places on the Web, including Reuters, MarketWatch and Yahoo! Finance. These are all solid filters and will give you the tools you need to get started. One of my favorite filters is at MSN Money. It's easy to use, powerful, and free. You can use prepackaged filters as well as your own, a huge positive in my book.

First, I want to weed out the smaller players and focus on stronger companies. I use my filter to discard any stocks with a capitalization of \$10 million or less and a stock price of \$10 or less.

The next most important factor to me is liquidity. I run the filter to select only those shares that are trading at least 500,000 shares a day on average daily volume over the past month. I'm left with stocks that are sufficiently liquid to give me decent spreads when it comes to buy and, ultimately, sell.

At this point, I usually have a list of a dozen or so companies. I feed them into my charting program and take a gander at the technical performance for each stock. I'm looking for well-formed uptrends on a weekly and, less importantly, daily basis -- that is, good long-term technical strength. I make a note of them and cross the others off my list.

You don't need a fancy charting program to get the job done. Most financial Web sites, including *RealMoney* and Yahoo! Finance, will work just fine.

Then I return to my filter, feed in my revised list of stocks and focus on valuation. I look at the P/E ratios of my stocks and how they compare to the industry average and the S&P 500. Those stocks that boast P/E averages way above -- leniently defined as more than double -- industry averages get cut here. For example, if the industry P/E is 20, I discard a stock trading at a P/E ratio of 40 or more. Industry P/Es are available from lots of sources, including Yahoo! Finance and *Reuters*, both for free.

My list of retail stock candidates is now down to a handful. It's time to put my filter away and begin to drill deep into each individual company. I'll focus on the company's position in the marketplace, its retail platform, brand quality, management and significant catalysts for future growth. I'll also take a deeper look at each company's detailed fundamentals , including recent financial performance, long-term growth rates and margin performance.

*Editor's note: Click here for part 2 of this column.*

At the time of publication, Burritt had no positions in any of the stocks mentioned in this column, although positions may change at any time. Wayne Burritt is president and director of equity research for Burritt Research, which operates BurrittResearch.com. Under no circumstances does the information in this column represent a recommendation to buy or sell stocks. Burritt appreciates your feedback; **click here** to send him an email.

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