Weeding Out Junk

Companies lose their luster for many reasons: competition, outdated or obsolete technology, new government regulations, reduced government reimbursements, ill-advised business strategies, poor management, and more. Whatever the problem, stock prices almost always follow company fundamentals when they head downhill.

When you've got a fresh annual or quarterly financial report, use the following list to look for signs of deterioration:

- **Slower growth in sales or earnings per share.** Slowing growth isn't the end of the world, but it might mean the end of satisfactory total returns for an investment. For example, if a company that was growing at 15 percent a year is wilting to single digit growth, the average annual total return you receive in the future is likely to wilt as well. If a company's slowing growth pulls the total return below the rate you want to achieve, consider selling the stock.

- **Erratic sales or earnings per share performance.** Quarterly numbers tend to bounce around a little bit, but big variations from year to year might indicate less than stellar company management. Besides, you might not like the volatile stock prices that are a common side-effect of erratic performance.

- **Declining profit margins, particularly when they drop below the industry average.** Profit margins represent the percentage of earnings with respect to revenue. If the profit margin falls, a company earns less on its sales, which often means slower earnings per share growth. Companies with little competition often sport high profit margins, so you can expect some declines as other companies produce similar products at lower cost. But, a profit margin that falls below the industry average is often a sign of a company that is losing its competitive edge.

- **Reduced dividend.** Most shareholders consider steadily increasing dividends as a sign of company strength and dependability, so companies do almost anything to avoid reducing the dividends that they pay. For that reason, a cut in the quarterly dividend is often a sign that the company is taking strong measures to correct a problem. Dig deeper to find the reason for the cut.

Some problems show up in words before they appear in the company numbers. Here are a few early warning signs to watch for in news or company reports:

- **Shrinking market share.** Losing a boatload of customers or even a few major ones is often a sign of problems somewhere in the organization.

- **Weakening product pipeline.** To maintain a steady profit margin, product companies must continually add new products to the mix to offset the lower margins on older products. If the pipeline gets long in the tooth, profit margins might decline, taking earnings down with them.

- **Decreasing research and development.** R&D is critical for companies in high-tech industries. Cuts in R&D funding often leads to fewer new products, lower profit margins, and lower earnings.