Driehaus Screen for Growth and Momentum Stocks

Momentum investors seek rapidly growing companies with prices to match.
Their hope is that continued growth will attract additional investors who will continue to drive up the stock price.

That investment philosophy, centered on earnings growth, underlies the approach used by Richard Driehaus, who was named to the Barron's All-Century Team of All-Stars in 2000. He and his Chicago-based firm, Driehaus Capital Management, look for companies with strong and accelerating earnings growth. Their belief is that earnings growth is the primary driver of stock prices, as sustained earnings growth allows a company to increase cash flows and dividends. In his book, "Investment Gurus" (Prentice Hall, 1999), Peter J. Tanous outlines Driehaus' momentum strategy.

The AAII Driehaus Screen

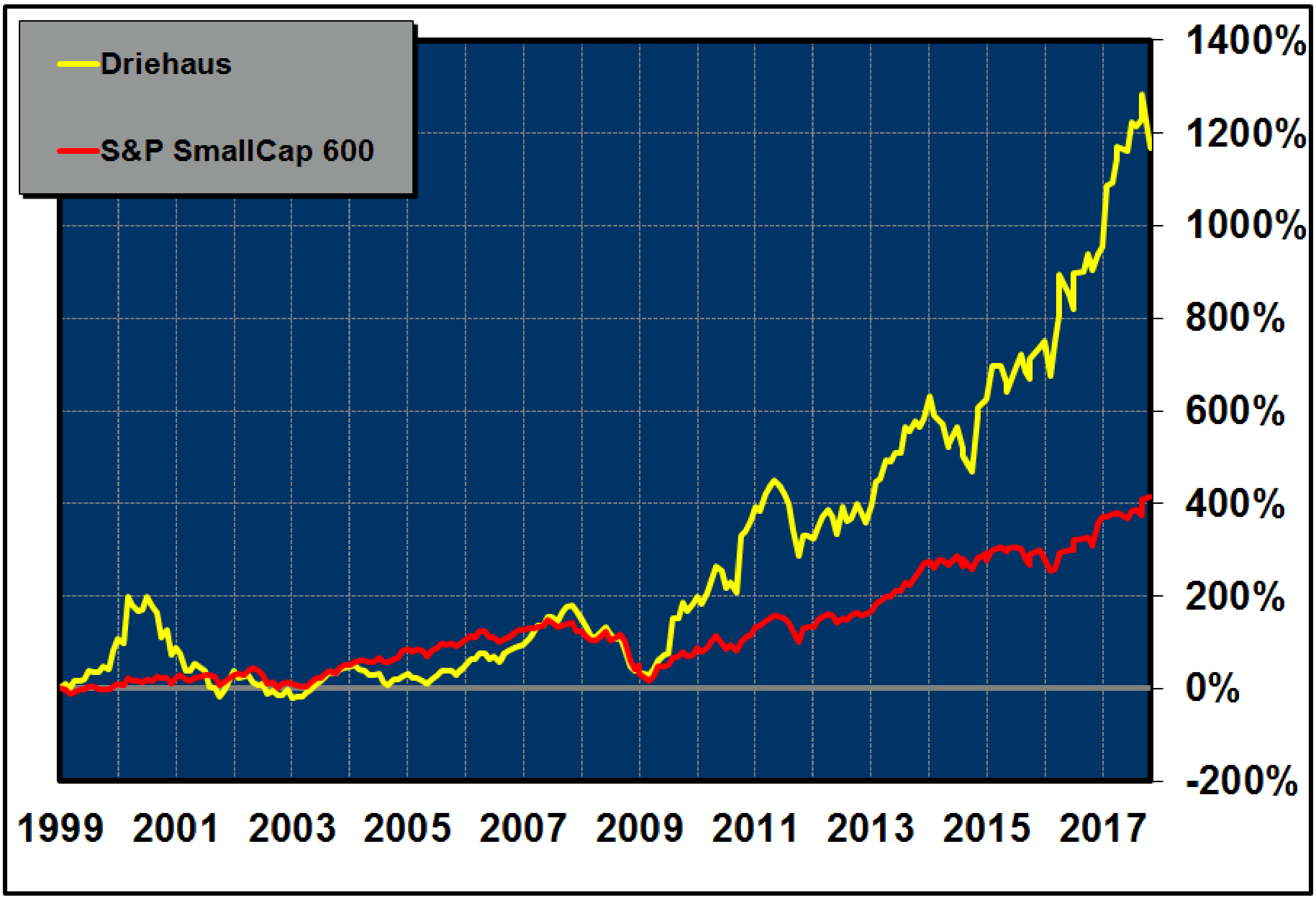
Based on Tanous' book, AAII developed a Driehaus screen, which we have built into our *Stock Investor Pro* fundamental stock screening and research database program and track at AAII.com. The AAII Driehaus screen isolates small and mid-cap companies with:

- Sufficient liquidity (daily trading volume);
- Year-over-year growth in earnings per share from continuing operations;
- Strong, positive earnings surprises; and
- Short-term price strength on an absolute basis as well as relative to a company's respective industry

The exact screening criteria used for the AAII Driehaus screen is located here.

Screen Performance

Each month, AAII.com lists the companies passing the Driehaus screen and tracks the performance of these stocks in a hypothetical portfolio.



The chart above shows the cumulative return of the AAII Driehaus screen since the beginning of 1999 through the end of May 2017. The AAII Driehaus screen generated an average annual price gain of 14.8% from the beginning of 1999 through the end of May 2017. Over that same period, the S&P 500 experienced an average annual price gain of 4.8%.

However, underlying this performance is high volatility. The screen has a risk index of 2.22, compared to 1.00 for the S&P 500. This means that this methodology has been 2.22 times more volatile than the large-cap index over the last 36 months.

During the last bear market, the Driehaus approach lost 53.4%, which was on par with the S&P indexes and the typical exchange-listed stock. However, since the end of the last bear market, the screen has returned an amazing 324.3%, compared to an 85.5% gain for the S&P 500 and a 279.8% gain for the typical exchange-listed stock.

Year-to-date, the Driehaus screen is up 19.4% through May 31.

Current Companies

Strong, accelerating earnings growth serves as the cornerstone of the Driehaus philosophy. The table below shows the five companies with the highest four-week price increase out of the 12 that passed the Driehaus screen as of June 22, 2017.

Company (Ticker)	Exchange	EPS Cont-Growth (%) 12m	1yr	Y3 to Y2	Y4 to Y3	Quarterly EPS Surprise (%)	($/shr)	Price Chg 4 wk (%)	Rel Strgth 26 wk (%) Index = 0	Ind Rel Strgth 26 wk (%) Index = 0	Mkt Cap ($ mil)
Mobileiron Inc. (MOBL)	Nasdaq	33.0	27.0	17.6	-199.2	27.7	(0.06)	26.0	49.0	4.4	590.0
IMPINJ Inc. (PI)	Nasdaq	82.9	34.0	5.5	-627.8	183.3	0.01	18.8	27.7	1.7	1127.9
Magnachip Semiconductor Corp. (MX)	New York	112.9	65.6	28.3	-88.9	111.1	0.01	10.5	38.4	6.0	317.5
MEI Pharma Inc. (MEIP)	Nasdaq	102.7	47.7	14.3	-22.9	42.9	(0.02)	9.7	40.9	-4.8	78.3
Pattern Energy Group Inc. (PEGI)	Nasdaq	127.1	53.3	37.6	-322.1	87.5	0.06	8.3	19.2	1.0	2123.8

EPS Growth

In order to pass the AAII Driehaus screen, a company must have increased the annual growth rate in earnings per share from continuing operations over each of the last two fiscal years. In addition, the growth rate for earnings per share from continuing operations over the last four quarters (trailing 12 months) must be positive.

Looking at this value for companies in shown above, we see that Pattern Energy Group (PEGI) leads all other companies with 127.1% growth rate over the last 12 months. However, three of the five companies in the list have all seen earnings grow by over 100% over the last four quarters. The company, which is an independent power company focusing on wind power projects, earned $0.13 per share over the last four fiscal quarters, compared to a loss of $0.48 per share for the four quarters prior.

Earnings Surprises

Driehaus believes that one way to identify companies with strong earnings growth that are apt to continue that trend is by locating those with “significant” positive earnings surprises—when the company’s actual announced earnings beat the consensus analyst estimate. The AAII Driehaus screen deems a “significant” surprise to be at least 10%.

Among the companies listed here, IMPINJ Inc. (PI) has the highest percentage earnings surprise of 183.3%. On May 4, 2017, the company announced earnings per share of $0.01, whereas the analysts tracking it had predicted a loss of $0.012 per share.

Given that many rapidly growing small- and mid-cap companies are usually not yet profitable, don't be surprised by the companies reporting negative "normalized" earnings per share for the latest completed fiscal quarter.

The number of analysts tracking a company is an important factor. Coverage by only one analyst limits the usefulness of an earnings estimate; as more analysts cover a company the consensus estimate becomes more credible. Therefore, the AAII Driehaus screen requires that at least three analysts offer estimates for the current fiscal quarter.

Price Momentum

Beyond earnings growth and positive earnings surprises, Driehaus also monitors price momentum. The AAII Driehaus screen looks for stocks with an increase in price over the last four weeks. We ranked the companies in the table above in descending order by the four-week price change.

Among these five companies, Mobileiron Inc. (MOBL) has seen the largest price increase over the last four weeks, rising 26% through the close on June 22, 2017. On June 12, MOBL shares jumped 12.3% although there was no company-specific news.

Another measure of momentum is relative price strength, which indicates how well a stock has performed compared to some benchmark—usually a market or industry index. Driehaus tries to invest in industry leaders, both in terms of earnings growth and as price performance. Therefore, the AAII Driehaus criteria also require that a company have a 26-week relative strength value that is equal to or above the median relative strength for all the companies in its industry over the same period. MOBL shares have outperformed the S&P 500 index by 49% over the last 26 weeks, while the companies in its industry have outperformed the index by 15.9%, on average.

What It Takes: Driehaus Criteria

- The year-to-year growth rate in earnings per share from continuing operations has increased over each of the last four fiscal years (Y4 to Y3, Y3 to Y2, etc.)
- Growth in earnings per share from continuing operations over the last 12 months has been positive
- The percentage difference between the actual announced earnings and the consensus earnings estimate for the same period—quarterly surprise—is greater than or equal to 10%
- At least three analysts have provided earnings estimates for the current fiscal quarter (Q0)

- The percentage change in stock price over the last four weeks is positive
- The 26-week relative price strength is greater than or equal to the industry's 26-week relative price strength
  – As a manual screen, users may wish to eliminate those companies that have underperformed the S&P 500 over the last 26 weeks (26-week relative strength less than zero)
  – This criterion is not used to generate the list of passing companies that appears on the AAII website
- The market capitalization for the latest fiscal quarter (Q1) is greater than $50 million and less than $3 billion
- Those companies that trade as American depositary receipts (ADRs) are excluded
- The average daily volume for the last 10 days is in the top 50% of the database (percent rank is greater than or equal to 50)

Conclusion

The momentum approach to stock selection developed by Richard Driehaus seeks to hit the "home run" that will provide above-normal returns. When investing in such potentially volatile stocks, it is very important to have a system in place that gets you out of a trade with only a minimal loss, while allowing the winners to ride until their momentum burns out. As the tech bubble of the late 1990s and the financial crisis of 2008–2009 showed, momentum strategies can crash back to earth very quickly, with potentially devastating consequences for investors.

As always, keep in mind that screening is only the first step in the investment process. The stocks passing this or any other screen do not represent a "recommended" or "buy" list. Before making any investment decisions, it is important to perform sufficient due diligence to identify those stocks that match your investing tolerances and constraints.

> **Click here for the latest passing companies and performance data.**