How Jim Cramer Picks Stocks

"How do I pick stocks? That's the question that everybody would love to know the answer to. Tonight you get a piece of that answer."

First, one of the easiest ways that he identifies potential Cramer names — the stocks that might end up on the show — is by watching the new-high list.

"Stocks on that illustrious list, the highest of the high, obviously have something going for them," Cramer said. "Either they're part of a major bull market, or the individual stocks themselves have serious momentum. No matter how they get there, most stocks on the new-high list keep going higher."

However, he doesn't simply pick names off that list. "That would be lazy and irresponsible," Cramer said. Instead, he waits for something to pull back from the new-high list.

"This gives you a good, lower-priced entry point in a stock that's probably going to rebound," he explained.

At the same time, market players should only buy stocks that have pulled back from the list if they are confident that these stocks will make a comeback. "You have to do all the same homework you'd ordinarily do before buying a stock," Cramer stressed.

"And the biggest caveat of all: When you're shopping for stocks that have pulled back from their highs, make sure they haven't pulled back for a good reason."

Insider High

Cramer's second method to his madness is that if insiders are buying a stock when it's at its 52-week high, "that is a clear sign that you want in."

Cramer said he loves it when he sees insiders buying at the high, because "it's a great sign of their confidence in the business."

Sometimes insider buying is "meaningless" and, on its own, an "insufficient" reason to buy a stock. "A lot of times you'll catch insiders buying their stock because they want to give the impression of confidence, to create an illusion that they're doing better than they in fact are," Cramer said.

But then there are times when there is "truly colossal" insider buying. "It's a pretty powerful endorsement when the insiders buy a whole lot of stock," especially when the buying is occurring at the stock's high, he said.

"It's a pretty good reason to give someone the benefit of the doubt," Cramer said. "These guys are not going to buy at the high unless they have some unshakeable conviction about their companies."

Most investors are smart enough to wait for a pullback before they pull the trigger. Therefore, insider buying at the high tells Cramer that investors don't believe there will be a pullback, "and there's nothing more bullish than that," he said.

The bottom line on Cramer's third method is that insider buying, coupled with a heavy short position, also equals a buy, Cramer said. "This is an explosive combination, and more often than not, it means there's going to be a short squeeze," meaning that the shorts will start buying to cover themselves.

Smart Shorts

"Shorts are smart. In fact, a lot of the time they tend to be smarter than regular long-side investors, but they don't know more about a business than the insiders who run it," he went on to say.

"If a lot of people are shorting a stock and management is buying it, usually —do your homework — you're going to want to side with management, and then you can ride a short squeeze higher and higher."

The fourth method to his madness, Cramer said, is trading around a core position. Going through the process step by step, he said the first thing people need to do is find a stock. "Find a stock that you believe will be going higher over the long term," Cramer said.

"What you're really looking for here is a great company that could get tossed around by market volatility but will go higher if you're patient."

If people were just investing, then they'd set up a position in the stock, buying in increments, he said. But if they wanted to trade, say, a 300-share core position of a $100-a-share stock, then every time the stock jumped three points, or 3%, they would sell 50 shares, Cramer said.

"You shave a little off to bring in some profits," he said.

Then people would wait for something to happen, as long as it doesn't hurt the basic fundamental outlook of the company they own, to knock the stock down a peg or two. "As the stock comes down, you buy it back in increments," Cramer said. "Since we started with 300 shares, let's keep using increments of 50 to buy it back."

Although all the trimming and adding of stock might not seem like much, "over time your profits add up," he said.

One important rule to remember when trading around a core position, Cramer said, is that when using the above-mentioned example, he would not own more than 300 shares or fewer than 100.

"The basic idea is to avoid putting yourself in a position where you have too much on the table in case the stock gets swatted down, or too little on the table to take advantage of any upside that comes your way," he said.

Cramer's final investing trick he wants to impart is the importance of realizing that "sooner or later, all hot stocks implode."

By "hot" stocks, Cramer means "small" stocks, or stocks with a low market-cap and very little research coverage, that have been going up for a long time.

"Small, hot" stocks are definitely worth owning, but people must know when to sell them, Cramer said. That moment usually comes when there are too many analysts jumping on the bandwagon.

Cramer would use four analysts as a good rule of thumb to let people know when to get out.

"Hot stocks get tapped out when there's nobody left to be attracted to them — when all the people who are going to buy have already bought," Cramer said. A great example of this in recent years is **Hansen Natural (HANS),** "which was the hottest stock in 2004, the hottest stock in 2005, and the hottest stock for the first half of 2006."

The stock, he said, peaked in July of 2006, partly because the company did a five-for-one split, which encouraged people who'd been in Hansen for a long time to take something off the table.

Another reason Cramer believed it would peak is because Hansen had just picked up its fourth analyst on May 10, 2006, when Goldman Sachs started covering the stock.