Introduction to Value Investing

If you are an investor, there is no perfect way to analyze a stock. Even so, many successful investors will tell you that focusing on certain fundamental metrics is the path to cashing in on potential gains. That is why you need to keep your eye on the metrics that matter.

Value investors believe that when it comes to a company's health, the fundamentals are king. Fundamentals, which include a company's financial, and operational data are preferred by some of the most successful investors in history, including the likes of Ben Graham and Warren Buffett. That is no surprise, as knowing the ins and outs of a company's financial numbers—like earnings per share and sales growth—can help an in-the-know investor weed out the stocks that are trading for less than they are worth.

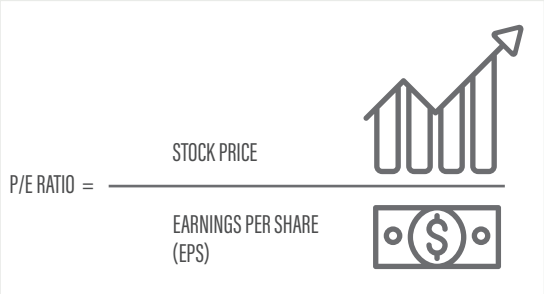
But that does not mean that all metrics are created equal—some deserve more of your attention than others. Here is a look at the five important fundamentals for the value portion of your investment portfolio.

INVESTMENT ESSENTIALS

EQUITY STRATEGIES

1. Price-to-Earnings Ratio

The price-to-earnings ratio (also known as the P/E ratio or earnings multiple) is one of the best-known fundamental ratios, and rightfully so. It is also one of the most valuable.



The P/E ratio divides a stock's share price by its earnings per share[1] to come up with a value that represents how much investors are willing to expend for each dollar of a company's earnings.

This ratio is important because it provides a measuring stick to compare valuations across companies. Therefore, a stock with a lower P/E ratio costs less per share for the same level of financial performance than one with a higher P/E. Naturally, an investor would want to pay less for the same return, which essentially means that a P/E ratio is often the way to go.

Keep in mind that the P/E ratio should not be compared across different industries. While it is completely reasonable to see a telecom stock such as Verizon or AT&T with a P/E in the teens, the average P/E ratios of other industries can be less or significantly more than that. As long as apples are compared to apples, the P/E ratio can give an excellent glimpse at a stock's valuation.

2. Price-to-Book Ratio

If the P/E ratio is a good indicator of what investors are paying for each dollar of a company's earnings, the price-to-book ratio (or P/B ratio) is an equally good indicator of what investors are willing to pay for each dollar of a company's assets. The P/B ratio divides a stock's share price by its net assets, less any intangibles, such as goodwill.[2]

Taking out intangibles is an important element of the price-to-book ratio. It means that the P/B ratio indicates what investors are paying for real-world tangible assets, not the harder-to-value intangibles. Therefore, the P/B is considered a relatively conservative metric.

That is not to say that the P/B ratio is not without its limitations; for companies that have significant intangibles, the price-to-book ratio can be misleadingly high. For most stocks, however, shooting for a P/B of 1.5 or less is a good path to solid value. A low P/B ratio can indicate an undervalued company, but it can also be a sign of a company in distress.

3. Debt to Equity

Debt to Equity is calculated by dividing a company's total liabilities by its stockholders' equity[3]. It can be used to measure a company's financial leverage. Knowing how a company finances its assets is essential for any investor—especially if you are on the prowl for the next big value stock. That is where the debt/equity ratio comes in. Much like the P/E ratio, the P/B ratio indicates what proportion of financing a company has received from debt (like loans or bonds) and equity (like the issuance of shares of stock), and it can vary from industry to industry.

Beware of above-industry debt/equity numbers, especially when an industry is facing tough times—it could be one of your first signs that a company is getting over its head in debt. For example, Lehman Brothers had a debt/equity ratio of over 30:1 in 2007 before its bankruptcy. That means that for every dollar of equity, the bank had $30 in debt.

[1] Earnings Per Share (EPS) is a company's profits per share of common stock.

[2] Goodwill is an intangible asset that arises when one company purchases another for a premium value.

[3] Stockholder's equity, also referred to as shareholders' equity, is the remaining amount of assets available to shareholders after all liabilities have been paid.

4. Free Cash Flow

Perhaps unbeknownst to many, a company's earnings are rarely equal to the amount of cash it brings in, because public companies tend to report their financials using Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS) accounting principles—or accrual accounting—not the balance of the corporate checking account. So while a company could be reporting a huge profit for its latest quarter, the corporate coffers could be bare.

Free cash flow solves this problem. It tells an investor how much actual cash a company is left with after any capital investments. Generally speaking, an investor wants positive free cash flow. As with the debt-equity ratio, this metric is all the more significant when times are tough.

5. Price/Earnings to Growth Ratio

The price/earnings to growth ratio (or PEG ratio) is a modified version of the P/E ratio that also takes earnings growth[4] into account. Looking for stocks based on their PEG ratios can be a good way to find companies that are undervalued but growing, and could gain attention in upcoming quarters. Like the P/E ratio, this metric varies from industry to industry.

Conclusion

When it comes to investing, ratios are not everything. There are times when low valuations are justified, and there are qualitative metrics—like management quality—that also factor into a company's valuation. Just because a stock seems cheap does not mean that it deserves to increase in value.

> Ultimately, the only way to improve your fundamental analysis skills is to put them into practice.

[4] The PEG Ratio is equal to the Price/Earnings ratio divided by the projected EPS growth.

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