

Investtalk *InfoSheet*: Basic Valuation

Research is extremely important when picking stocks to own.

Even with a portfolio of strong growing companies, you will still have a difficult time consistently making money in a market that is in a long Secular Bear phase in which we find ourselves. Your number one goal is to outperform the market. Even if your portfolio is negative in a particular year, but on a percentage basis you outperformed the indexes, you are doing a great job. Remember, the stock market has an average return over the last 100+ years of about 10 percent. Here are some simple fundamental guidelines to use when searching for quality companies.

Always look at the company's earnings yield. Money managers often compare the earnings yield of a broad market index (such as the S&P 500) to prevailing interest rates such as the current 10-year Treasury yield. If the earnings yield is less than the rate of the 10-year Treasury yield, stocks as a whole may be considered overvalued. If the earnings yield is higher, stocks may be considered undervalued relative to bonds. We like the yield to be a 150% of the 10 year treasury. The reason we want a 150% premium in stock yield to treasury bond yield is because there is no risk in treasuries but there is in stocks.

The growth-to-P/E ratio. GPE is high and usually greater than two. These stocks are good candidates to buy. High GPEs give a good indication that the company is not overvalued compared to the P/E. This keeps you in companies that are not only growing but also making money. Sales growth does not always equal earnings growth. This formula addresses that issue. Earnings is always king.

We typically like companies with a low price-to-sales ratio. However you should only compare the P/S ratio across industries because profit margins have a large impact on what the P/S number will be. Tech companies usually have large P/S whereas retail companies will have very small P/S.

These are some basic fundamental features that you should use every time you search for a company to invest in. Using these ratios will greatly increase your chance of owning stable companies with low probabilities of going out of business.

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