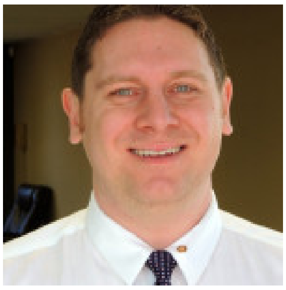
Money Matters: Analyzing a company's stock

By Nic Abelow

What makes a company a good investment? Investment professionals consider several factors when they're selecting companies to include in a stock portfolio. Here are some of the criteria they're likely to use.



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A company's finances

A strong financial position on the part of the issuing company can make a stock attractive to investors. Analysts typically look at the company's cash flow to evaluate how much money the company spends, how much it brings in, and how much "free" cash is left after the bills are paid. Reviewing revenues, net income, and earnings per share helps analysts assess the company's history of sales and earnings growth. Another gauge of financial health is the amount of debt the company has compared to equity.

A look at the business

Stocks of companies that are leaders in their industries generally are desirable choices for a portfolio. Analysts look for profitable companies with limited competition whose products or services are valuable to customers. Keeping an eye on earnings estimates helps analysts determine whether the company is likely to experience rising profits or unexpected slowdowns in the future.

Valuing stock

Analysts use different calculations to assess a stock’s relative value. Some of the most common include:

Price-to-earnings ratio (P/E) shows the relationship between the current stock price and the company’s projected earnings. The P/E is one of the most widely used ratios, and it is used to compare the financial performance of different companies, industries, and markets. The company’s forecast P/E (its P/E for the upcoming year) is generally considered more important than its historical P/E.

Price-to-book ratio (P/B) is a stock’s current price divided by its book value (i.e., total assets minus total liabilities) per share. Both can help identify potentially undervalued stocks and also may be reliable indicators of investor sentiment. Like most ratios, it’s best to compare P/B ratios within industries. For example, tech stocks often trade above book value, while financial stocks often trade below book value.

Return on equity (ROE) is calculated by dividing a company’s earnings per share by its book value per share. The ROE is a measure of how well the company is utilizing its assets to make money. Understanding the trend of ROE is important because it indicates whether the company is improving its financial position or not.

Dividend payout ratio is calculated by dividing the dividends paid by a company by its earnings. The dividend payout ratio can also be calculated as dividends per share divided by earnings per share. A high dividend payout ratio indicates that the company is returning a large percentage of company profits back to the shareholders. A low dividend payout ratio indicates that the company is retaining most of its profits for internal growth.

The personal factor

While metrics are critical to analyzing a company’s stock and whether it may be a good addition to an investor’s portfolio, personal circumstances – e.g., an investor’s other portfolio holdings, goals, time frame, and risk tolerance – should always be considered when determining whether a stock is right for a particular portfolio.

Nic Abelow is a certified financial planner and LPL financial advisor with Abelow, Pratt & Associates Financial Advisors and Wealth Management in Lake Tahoe.