CIBC
Wood Gundy

Equities – The "Value Approach"

Whether you're a seasoned pro or new to the world of investing, playing the stock market is not for the faint-of-heart. So before you begin, it's useful to have an understanding of the types of companies and stocks you can invest in and the different approaches and techniques that can be used in the selection process. The approach you use should reflect your investment needs and should help you to achieve your long-term financial goals.

If you utilize the "value" approach to investing in stocks, you are a value investor. Your objective is to find the undervalued situation and then hold the stock until the marketplace begins to realize the undervaluation and bids the price of the stock up. The value-oriented approach tends to be a longer-term style of investing. The assumption is that the market will eventually recognize the value of the stock, and the price will rise.

There are many approaches to value investing. Some value buyers may look for more than one measure of undervaluation before they purchase a stock; others may look for only one such relative measure.

When following a value-oriented approach, you would look at a number of measurements of a company's valuation and compare them to industry or market norms. Some of the major valuation measures are:

Price-to-Earnings Ratio (P/E)

Stocks have a P/E ratio. This ratio is determined by dividing the price of a stock by the company's net earnings per share. This ratio tells how much investors are willing to pay today for $1 of the company's earnings.

It's important to realize that different industries tend to sell at different levels of P/E ratios. To determine if a company is selling below normal P/E, compare the P/E of a particular stock to that stock's historical P/E ratio, the composite P/E for the industry and the P/E of the market. If you determine that the company is selling at a relatively low P/E, try to determine the cause. Are the company's earnings below normal? Is there a problem with the company, or is this merely an undervalued situation whose potential has yet to be discovered?

Price-to-Book Value Ratios

Book value is the value of a company's total assets minus total liabilities. In the case of price-to-book value, it is important to keep in mind that there are differences among industry groups. For example, a steel company would tend to trade at a lower price-to-book value since such a company would have a much greater level of hard assets than would a computer software company whose main assets might be copyrights on software programs and the programming knowledge of its employees.

To calculate price-to-book ratio, take the assets of a company and subtract the liabilities, intangible assets and uncapitalized lease obligations. Divide this value by the number of shares outstanding. As with the P/E, compare this ratio to the market, the industry group and historic norms to determine if the company's current price implies a relative undervaluation.

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Price-to-Cash Flow Ratios

This measure is popular among value investors because earnings are easier for a company to affect than cash flow. As with price-to-book value ratios, look to identify those companies trading at low price-to-cash flow ratios. Keep in mind that cash flow ratios can vary from industry to industry.

Dividend Yield

If you are value investor, you would try to compare a company's dividend yield to the market, its industry group and the historic norm for the company, to see if the stock is selling at a higher than normal yield. If so, you would try to determine why this is the case. It may be that the market is anticipating a dividend reduction. Keep in mind that dividends also vary among industries. Utility stocks for example, tend to trade at a higher yield than do food companies. To calculate dividend yield, divide the annual dividend the company pays its common stockholders by the price of the stock.

By including value stocks in your portfolio - in addition to other types and styles of investments - you are ensuring it's well by in diversified and that you're not "putting all your investment eggs in one basket."

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