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Investing

Other variables to consider when assessing stocks

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In the past I've discussed using specific variables, such as price-to-earnings (P/E) ratios and dividend yields, for picking stocks. Both these variables have strong track records. But they're not the only ones we use. Using more variables – provided they are effective and make sense – gives us a well-rounded approach in making stock choices.

For example, if we only used dividend yields to pick stocks, we would exclude many good companies that are strongly growing their businesses. Or, by using just P/E ratios, we might exclude companies that have high depreciation or depletion expenses, such as oil production companies.

The good news about the other variables we can use is that they have similar characteristics to P/E ratios and dividend yields. However, these variables look at companies from slightly different angles – this gives us a more complete picture of which stocks have a better chance of doing well. In this article, I'll briefly discuss three of them: *price-to-cash flow*, *price-to-sales* and *price-to-book*.

First, let's consider *price-to-cash flow*. Cash flow is net income, but without depreciation and other non-cash expenses. It's sometimes preferable to P/E ratio because cash flow is more difficult to manipulate than earnings. Also, it's better for comparing companies that have high or variable amortization, depletion or depreciation expenses. Study the record. Over 45 years, picking low price-to-cash flow stocks outperformed the average by five percent (16.2 percent vs. 11.2 percent). High price-to-cash flow stocks did much worse, returning only 3.5 percent vs. the average of 11.2 percent.

Price-to-sales is similar to P/E, but it measures price against the annual sales instead of earnings. Over 45 years, picking low price-to-sales stocks returned 14.5 percent vs. 11.2 percent for the benchmark. On the other hand, high price-to-sales stocks returned only 3.3 percent.

Price-to-book is the current price divided by a company's book value. Book value is about what the assets, such as machinery or property, would be worth if you liquidated them. Over 45 years, picking low price-to-book stocks returned 13.8 percent vs. 11.2 percent for the benchmark. But high price-to-sales stocks returned only 8.8 percent.

You might notice that the amount of extra performance is not as much with price-to-book. That doesn't make it a less useful variable than, say, P/E. The reason is we don't use these variables in isolation. Rather, we combine them to pick the best overall stocks. For example, it's better to choose a stock that is pretty good with *all* these variables, rather than one that is outstanding in just one variable, and mediocre in the remaining variables. Sure, there will be a time when one factor does extremely well – the problem is we don't know when that will be. Combining variables reduces periods of underperformance and improves consistency of outperformance.

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