INVESTING

Basic Ratios in Stock Evaluation

How do investors determine which company shares to buy? Two businesses might be as comparable as apples and oranges, so how can a person determine the true value of owning a share in the company?

Earnings per Share

A standard way to compare shares of different companies is to look at how their profits are spread among investors. Earnings per share (EPS) is a dollar value that shows exactly what its name suggests: the amount of money the company earns for each share owned.

EPS is not a very descriptive value on its own. A company's earnings can be greatly reduced by a year of slumped sales or by committed funds that must be paid to bondholders or preferred stock holders. Additionally, the EPS can be decreased by the total number of shares issued. For instance, Company A might earn $150 million, but if they have 50 million shares of common stock, its EPS will be no better than Company B that earned $15,000 and had 5,000 shares.

In theory, if two companies were identical in every other way, it would be advantageous for an investor to buy shares in the one with the higher EPS. However, since EPS is only a tiny piece of information, it should never dictate which investments a person makes.

Price to Earnings Ratio

The price to earnings ratio (P/E) is a number that relates a share's price to its EPS. It expresses how much money an investor must pay for each dollar of a company's earning power.

Consider Company A and Company B listed before; both have an EPS of $3. An investor watching the market notices that Company A's shares are selling for $21 each while Company B's shares are just $6 a share. This means Company A has a P/E of 7 and Company B has a P/E of 2. As it stands, Company B looks like a better value because the investor needs to spend $5 less for each dollar of earnings.

> A PEG ratio is based on the speculation that a company will grow at a certain rate. PEGs are not historical statistics; they are estimations of future performance.

P/E ratios can be used to compare the value between two different shares, but, like EPS, they are not the full story. Company B features a stronger

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looking P/E, but Company A clearly has the advantage of size and (most likely) stability. Company B is selling at a value because the market thinks it is much riskier to own. Investors can use P/E ratios to help them decide between two very similar companies, but, on their own, the ratios are useless.

Price to Earnings to Growth

The next step factors in the future value of the company as its value increases with growth. This price to earnings to growth (P/E/G or PEG) helps investors determine which company will have a better P/E ratio in the future.

Look at Company A and Company B once again: Company A has a P/E of 7 and Company B has a P/E of 2. Company A is well established and, as such, is only expected to see a 2 percent growth this year, while Company B should see growth of 6 percent. To figure out the PEG, the P/E is simply divided by the numeral value of the growth. This means Company A has a PEG of 3.5 and Company B has a PEG of .33. Much like with P/E, lower ratios indicate a seemingly better value of an investment.

As with the other two factors, PEG is not a complete picture. Looking at a company's PEG will provide an investor with relatively meaningless data. Additionally, unlike P/E and EPS, a PEG ratio is based on the speculation that a company will grow at a certain rate. PEGs are not historical statistics; they are estimations of future performance—which is never guaranteed.

Looking Elsewhere

When looking at the EPS, P/E and PEG of Company A and Company B together, an investor might be tempted to invest in the latter. Though both have the same EPS, Company B seems like a much better deal. Each dollar of earnings is cheaper to purchase and the company has a growth rate that should outpace Company A.

However, what if Company B is in an industry where growth rates average 9 percent? Isn't it at risk of being crowded out by its faster competitors? Or, what if Company A only had a low EPS because it made recent infrastructure improvements that will provide larger profits in the future? By themselves, EPS, P/E and PEG figures are unable to report fundamental differences or weaknesses between companies.

There is a vast array of charts and metrics for use when trying to find the best stocks, but investors have learned that things do not usually go according to plan. In a world of surplus amounts of information, databases and super computers, no one has found the perfect formula or ratio for investing. Furthermore, historical data are never a guarantee of future results; the market is as influenced by the mindset and moods of people as it is by numbers.

If you are considering investing directly in a company, experience can be the difference between success and failure. Talk to Northern Oak Wealth Management, Inc. before you make any direct investments to get professional input on what you are seeing in the market.

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