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How the Pros Tell If a Stock Is a Bargain

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Are stocks cheap or expensive?

That's the key question on the heels of an impressive rally that has taken the Dow Jones Industrial Average up 14% this year. Most of the gains have come in just the past few months, although the benchmark took a breather last week, sliding 0.7%. (The Nasdaq Composite Index is up 9.4%, after losing 1.9% last week.)

Big gains sometimes elicit caution from market commentators, but they don't always mean that stocks are too expensive in relation to companies' earnings and business prospects. Similarly, this year's double-digit growth in corporate earnings doesn't necessarily mean stocks are attractive.

Investing pros use a group of financial ratios to figure out whether the market, and individual stocks, are cheap or pricey relative to company fundamentals. None of these formulas is enough on its own, but together they can help locate attractive companies.

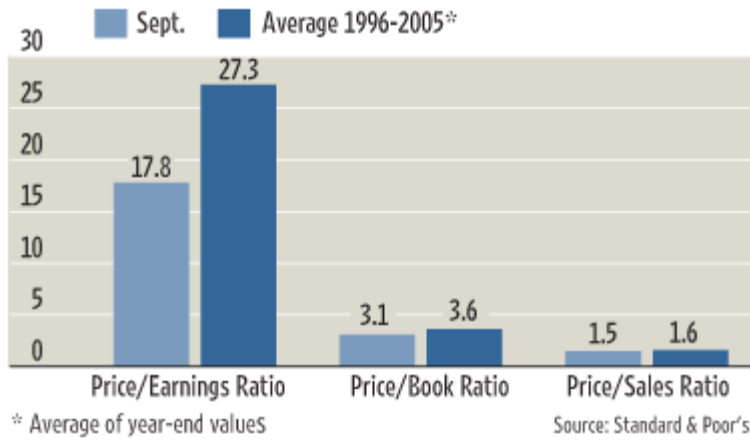
Here's a look at five measures, which generally suggest that the stock market is reasonably priced, though not in bargain territory.

Price/Earnings Ratio

The ratio of a company's stock price to its per-share earnings is the granddaddy of investment metrics. Stockholders are the owners of a public company, so the stock value depends on the company's earnings. If a stock sells for \$20 and the company earns \$1 a share, the P/E ratio is 20. The higher the ratio, the more expensive a stock is in relation to its earnings.

Taking the Market's Measure

Here's how the Standard & Poor's 500-stock index stacks up on three measures of valuation, compared to the average readings of the past decade. Lower figures suggest stocks are more reasonably priced.



It is best to compare a stock's P/E with that of industry peers as well as the overall market. If a company is trading at a relatively high P/E, it means investors have high hopes and are willing to pay up. That could work out well if the hopes are met, but any disappointments could send shares tumbling.

Academic research demonstrates that buying low-P/E shares is a recipe for success. Several years ago, Warren Buffett bought several Korean stocks when their P/E ratios reached low-single-digit levels; the stocks eventually climbed. Robert Howell, a professor at Dartmouth's Tuck School of Business, says he generally avoids stocks with P/E ratios above 20.

The market is somewhat attractive based on P/E. The Standard & Poor's 500-stock index, which tracks the largest companies, trades at a P/E ratio of 17.8 based on the past 12 months of earnings. That is lower than the average P/E range of 19.2 since 1980.

Note that a company can inflate earnings -- and lower its P/E -- by adjusting things such as the rate at which it depreciates the value of a factory. And sometimes P/E ratios are low for a good reason: Past earnings were strong but future earnings are expected to tumble.

Price/Free Cash Flow

Rather than reported earnings, many successful pros focus on free cash flow, or the cash income that a company is left with after paying expenses. If a stock has a low ratio of price to free cash flow, that suggests it is a healthy business that has a lot of money left over for dividends, stock buybacks or other steps to improve a stock's return.

One current example: oil giant **ConocoPhillips** (COP).

This is a measure that should get greater use than it does, because "the value of a business, at the end of the day, is nothing more" than the current value of its future

free cash flows, says Anant Sundaram, who teaches stock valuation at the Tuck School.

To figure a company's free cash flow, go to the "cash flow statement" in shareholder reports. Take operating cash flows and subtract all capital expenditures, or money reinvested in the business. For companies with a lot of debt or that hold a lot of cash, it is best to also take out interest expense and interest income.

The one catch with focusing on multiples of current cash flows: They could look good if a company is shortchanging its future value by not putting enough money into growing its business.

"A stock that trades at a low multiple of free cash flow...may be cheap," says Aswath Damodaran, who teaches at New York University's Stern School of Business. "Or it may have substandard investments and a huge need for reinvestment."

Stocks now trade at less attractive levels in relation to cash flows than they did earlier this year, but this year's figures are among the most attractive since 1996.

Price/Book Value

Book value is a measure of a company's assets minus its outstanding debt or other obligations. If a company's shares are worth \$2 billion and its book value is \$1 billion, then it is trading at two times book value.

A low price-to-book ratio can give comfort to an investor. That's because a company's book value can be a good starting point in estimating the firm's value in the event it had to be liquidated.

The S&P 500 currently trades at 3.1 times book value, about the level of the past few years though below the expensive level of about 4.5 in the late 1990s.

Price-to-book is a key metric for financial companies and homebuilders, but is less important for some other industries because book value doesn't include things such as patents, research and development and brands or the creativity of workers. So pharmaceutical and technology companies tend to have low book values -- and high price-to-book ratios.

"Price-to-book can be meaningful, or totally irrelevant, depending on the kind of business," says Terry O'Connor, who runs hedge fund Cedar Creek in Summit, N. J. "Book value is very relevant in valuing financial institutions, probably irrelevant at software companies."

Price/Sales

Some pros like stocks with a lot of sales compared to their price, or a low price-to-sales ratio. So a company with shares worth \$500 million and sales of \$1 billion would have an attractive price-to-sales of 0.5.

But sales don't guarantee profits. So companies with low price-to-sales ratios should have a good plan to turn those big sales into earnings, or the stocks won't benefit.

Companies in the S&P 500 now trade at 1.5 times their sales, close to the level of recent years but above levels of the early 1990's.

Return on Invested Capital

Jack Ablin, chief investment officer at Harris Private Bank in Chicago, urges investors to focus on a company's so-called return on invested capital, or how much profit it generates from the amount it invests in its operations.

To get that figure, he divides a company's earnings (before interest and taxes) by total assets. On that basis, he says engine maker **Cummins** (CMI) is attractive.

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