Why You Should Ignore Share Prices

Description

It's easy to get caught up in stock prices as they move up and down, especially when there are large swings. However, focusing on share prices can actually be hazardous to your portfolio's health if you end up overtrading due to emotion.

Here's why you should ignore share prices and focus on other things that are more telling.

Why share prices don't tell you much

The share price doesn't tell you much in terms of what value you're getting for what you are paying. Adding the price-to-earnings ratio (P/E) to the picture makes it clearer.

In 2008 during the financial crisis, **Bank of Nova Scotia** (TSX:BNS)(NYSE:BNS) traded at about $37 per share at one point.

It turned out it was trading at a P/E of about 9.5. So, if you bought shares then, you would have paid $9.50 for every $1 of the bank's earnings.

Early this year Bank of Nova Scotia traded at about $55 per share. It was trading at a P/E of 9.5 again!

Don't miss out!

Comparing your previous cost basis of $37 to the $55 would have been meaningless without comparing the P/Es.

If you were focused on the share price, you might have missed out on a buying opportunity in a great bank, which has rallied 29% to $71 since the $55 level.

After buying shares of a company, some investors don't add to their position unless the share price falls at least to their cost basis. After the Bank of Nova Scotia example, you should have learned to think otherwise.

What's more important than the share price

If you're investing for the long term, there are many more important things you should focus on rather than the share price of a company.

It's useful to compare a company's P/E with its historical P/E or with its peers' P/Es.

At about $71 per share, Bank of Nova Scotia trades at a P/E of about 12. This is more expensive than it was when it traded at a P/E of 9.5 earlier this year.

Compared to **Royal Bank of Canada** and **Toronto-Dominion Bank**, Bank of Nova Scotia is trading at a small discount. Royal Bank and Toronto-Dominion trade at P/Es of 12.3 and 12.2, respectively. Compared to **Bank of Montreal** and **Canadian Imperial Bank of Commerce**, Bank of Nova Scotia trades at a premium.

Just looking at the P/E is not enough. There must be a reason for Bank of Nova Scotia's peers to trade at premiums or discounts. Companies that consistently trade at a premium to their peers indicate they may be higher-quality companies.

What about long-term profitability?

Before concerning themselves with the P/E of a company, investors should determine how the company increases its profits over time.

One simple metric to look at is the earnings per share (EPS). If a company you own has a long-term trend of growing its EPS, then you're in good hands.

From 2000 to 2015, Bank of Nova Scotia's EPS grew at a compounded annual growth rate of nearly 8.2%. In fact, if you'd invested in the bank in 2000, you would have enjoyed annualized returns of 10%.

And that doesn't include the returns of the received dividends that you could have reinvested for more returns. Additionally, your dividend yield would have grown from 3% to a yield on cost of 16% over the 15 years!

Conclusion

Share prices aren't very telling. For a clearer picture of whether a company is good for the long term, you should analyze the valuation and profitability of a company. And you can start by analyzing its P/E and EPS as I did in the Bank of Nova Scotia example.

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1. NYSE:BNS (The Bank of Nova Scotia)
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