How to Determine if a Stock Is Cheap or Expensive

Description

Some investors believe that investment success comes from the time in the market and not timing the market. If timing the market means aiming to buy shares of a company at a good valuation, then I will agree that timing the market will lead to a higher chance of investment success.

Here, I'm assuming you've already identified a great company that you want to be a part owner of. But maybe you're not sure what's a good price to get in.

Buying a company at a good valuation lowers the risk and increases the returns potential of the investment. Doing some valuation analysis by looking ahead and into the recent past of the company can place you ahead of many other investors. It can be as simple as a two-step process.

First, compare the company's current trading levels with its historical trading levels. Second, compare its growth rates in the past with its anticipated growth rate. After that, you should get an idea if the company is expensive, fairly valued, or cheap.

I'll bring you through the process using **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) as an example.

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Comparing current trading levels with the past

The top Canadian bank's five-year average price-to-earnings ratio (P/E) is 13.2, its average price-to-book ratio (P/B) is 1.8, its average price-to-sales ratio (P/S) is 3.3, and its average yield is 3.4%.

Currently, Toronto-Dominion Bank trades at a P/E of 14.4, a P/B of 1.8, a P/S of 3.6, and it has a dividend yield of nearly 3.3%.

Its various valuation multiples indicate that the stock is slightly more expensive compared to its recent history. A lower price leads to a higher yield if a company's dividend per share remains unchanged.

Since the bank's current yield is lower than its five-year average yield, its yield also indicates the shares are likely slightly on the expensive side.

Compare past growth rate with anticipated growth rate

In the last five fiscal years, Toronto-Dominion Bank's earnings per share grew at a compound annual growth rate of 7.4%. The consensus growth rate expectation across 19 analysts is 7.4% for the next three to five years. This aligns with the company's recent growth rate.

According to the growth rate expectation, a fair valuation for Toronto-Dominion Bank would be it trading at similar levels as it has in the past five years — that is roughly a P/E of 13.2.

Conclusion

At $67 per share, Toronto-Dominion Bank is trading within a fair valuation. Combining its growth rate and its dividend yield, the bank can deliver annualized returns of about 10%. However, this assumes that it will be trading at similar multiples down the road as it is today.

In other words, there's no margin of safety in the bank shares. Depending on individual shareholders, some may decide to take some profits, while others may choose to hold on to their shares. Yet there are others who may opt to buy some shares in this quality company at or near a fair valuation for a reasonable return.

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