How This Unpopular Ratio Can Boost Your Returns

Description

It’s all too easy to get carried away when share prices rise. Similarly, when they fall, many investors find it difficult to overcome the fear of further losses. That’s where value investing can prove to be a useful ally. It can help investors to judge whether it is the right time to buy or sell a share. Best of all, it produces cold, hard facts which help to push emotions to one side. Here’s one ratio used in value investing which, while not particularly exciting or popular, could allow you to make more effective decisions within your portfolio.

A simple concept

The ratio in question is the price-to-book (P/B) ratio. It is calculated by dividing a company’s market capitalisation by its net assets. This can also be done on a per share basis. Net asset value is a company’s total assets minus its total liabilities and essentially represents a base value for a business. In other words, if all of its liabilities were paid off and all assets were sold at their carrying value, the cash left over would be the net asset value.

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Goodwill

If a company has a P/B ratio of 1, it is trading at its net asset value. If it has a P/B ratio of more than 1, its share price carries an amount of goodwill. This is understandable, since a business is more than just a pile of assets and liabilities. Particularly among listed companies, a business is likely to have at least some brand recognition and customer loyalty. This is not represented in a set of accounts, and so it is normal for a company’s shares to trade at a premium to their book value.

Where a company has a P/B ratio of less than 1, the discount to net asset value could indicate either an extremely good value share price or potentially a value trap. For example, a number of banks have traded at below net asset value in recent years. This has largely been due to the potential for asset writedowns which could therefore reduce the value of net assets.

Standard practice

While there is no ‘magic’ P/B figure which investors should aim for, the ratio is useful in ascertaining whether a company offers good value for money. For example, a company may have historically traded on a P/B of 2, but now has a P/B of 4. In this scenario, it could be deduced that unless there has been some fundamental shift in the profile of the business or in its future prospects, it is overvalued. Similarly, a P/B falling to 1 from a historic average of 2 could indicate a buying opportunity.

As such, it is the relative number rather than the absolute number which may be most useful. A stock which has a much lower P/B ratio than its sector peers may be worth focusing on. Similarly, a company listed in a different region to its peers and having a relatively high P/B ratio may be a stock to avoid.

By focusing on the P/B ratio and taking a consistent approach, it is possible to find overvalued and undervalued stocks. The ratio also means you rely less on emotion and more on cold, hard facts when making investment decisions. In the long run, this could lead to improved overall returns.

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