5 Things You Should Know Before Buying a Stock

Description

Making an investment in the stock market can be an intimidating venture, particularly if it is your first time.

There are countless lessons to learn, and if you are committed to the process, you will undoubtedly learn many of these lessons over the years. Sometimes you will learn from your successes; however, every investor has made their share of mistakes throughout their investing careers, and, in many cases, these are the most valuable lessons.

In an attempt to avoid any costly mistakes, here are the five things you need to be aware of before making a purchase in the shares of a publicly traded company.

Understand the price you are paying

The first thing you should do is review financial websites to gain a basic understanding of the current valuation, or price, your company is trading for in the market.

Financial ratios, like the price-to-earnings ratio (P/E ratio) and price-to-book (P/B ratio) are often used by value investors to gauge market sentiment. Lower ratios indicating the stock is trading “on sale.”

The price-to-cash flow (P/CF) measure is also useful in evaluating the available cash the company has available to return to shareholders in the form of dividends and buybacks. Generally, a P/CF ratio of greater than 15 times will be a bit on the expensive side, so watch out for that.

Does your company pay a dividend?

Your company’s dividend yield will tell you the return you will be receiving on an annual basis in the form of dividend payments to your account.

A higher yield is generally preferred by investors; however, if your company's intent is to reinvest in its business to grow the company over the long term, you may be willing to accept a lower yield or no dividend at all.

Evaluate your company using financial ratios

The list of financial ratios is virtually endless, but you do want to check some of the more common metrics to assess your company's financial position and performance.

The current ratio, debt-to-equity ratio, operating margin, return-on-equity and financial leverage ratios are all considered "must-knows" by seasoned investors.

Review your company's annual information form

The annual information form, or more commonly referred to as the "annual report," is the best place to look if you want to do a deeper dive on your company.

Here you will find an overview of the company's products or services, any highlights from the past year, as well as management's commentary on past and future performance in the section titled "Management's Discussion and Analysis."

For example, in **Macdonald Dettwiler & Associates Ltd.'s** (TSX:MDA) annual report, management discusses the recent acquisition of **DigitalGlobe Inc** (NYSE:DGI) and its implications on the company's strategy to enter the lucrative U.S. government contract market.

Is the company going to be bigger in five years?

This would be one of the cardinal rules of investing. Unless you are strictly an income investor, you are making an investment because you expect the value of your shares to grow, which means the value of the company must also grow.

In order for the value of the business to grow, you will need to see growth in revenue, profits, or cash flow. If you aren't sure if this is the case with your company, you're probably better off looking elsewhere.

Conclusion

Investing in the stock market presents challenges, but for those who stick with it and persevere, there are many rewards, including being in control of your financial future.

Keep in mind these five tips and you will hopefully avoid some of the more common pitfalls encountered by most newbie investors.

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