This Ratio Could Boost Your Portfolio Returns

Description

Since global stock markets have risen significantly in recent years, it may be more important than ever to find the best opportunities within a particular industry or sector. Clearly, there are many different methods for doing so. However, they can be difficult to apply to a range of industries as a result of a narrow focus or other limitation.

With that in mind, here is a ratio which may prove useful for Foolish investors to use given the outlook for the global economy.

A simple calculation

The ratio in question is return on capital employed (ROCE). It provides a measure of a company's profitability, as well as guidance on how efficiently its capital is being employed. 'Capital' refers to how it is funded, which is through either debt, equity or both. Unlike return on equity which focuses solely on the returns to shareholders, ROCE encompasses the range of funding options for a business. This means that it can be used to provide a measure of efficiency for a larger range of companies that includes those with high debt levels.

ROCE is calculated by dividing operating profit (or earnings before interest and tax) by total capital employed. Total capital employed is total equity (or net assets) plus total debt. The end result is a percentage figure which can be used to compare the efficiency of companies operating within the same sector. The higher the percentage, the more efficient a company is at producing profit.

A useful ratio

Given that interest rates across the developed world have generally been low in the last decade, and are set to remain so in future, ROCE could be a useful ratio to use. It takes into account the use ofdebt in a company's capital structure, and this could make it a more relevant measure to utilise giventhe current conditions facing investors. That's because many companies have taken advantage of low borrowing costs to fund their future growth. This has resulted in relatively high leverage levels which need to be factored into the overall picture of a company's performance.

The ratio is also of use since it can be used to deduce changes in a company's efficiency over time. For example, a company which has been able to use its capital more effectively in recent years may be worthy of a higher valuation than a sector peer that has seen its ROCE ratio decline. With share prices generally being high, the ratio could therefore be another tool for investors to use when seeking relative outperformance in the long run.

Takeaway

While ROCE is insufficient to decide on the investment potential of a company on its own, it could help investors to compare a stock versus its sector peers. It can also highlight the improvements made by a business in recent years, and help to determine the fair price which should be paid in order to generate a favourable risk/reward ratio.

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Date
2025/08/26
Date Created
2017/11/18
Author
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