7 Questions Every Investor Should Ask Before Making an Investment

Description

Investing can be extremely complicated and comes with a high degree of risk. The number one goal of investors should be wealth preservation. It is important to understand everything you can about the business.

Knowing basic things, such as the dividend yield and P/E ratio is important, but it's only a start. Investors need to have a full idea of everything going on in the business so they can make an informed choice whether to make an investment. Here are seven questions to ask yourself before your next investment.

Do you understand the business?

It is important for investors to know how the company makes money. During the tech bubble in the early 2000s, Warren Buffett famously didn't invest in any of the tech stocks because he didn't understand how they made money. When the tech bubble finally burst, most people lost a lot of money.

It's impossible to value a company if you don't understand how it makes money. Therefore, the first thing to do is understand the business.

What does the business do better than anybody else?

Another way to ask this is, what advantage does it have over its competitors? In order for a company to be successful long term, it has to have some sort of advantage over its competitors. Without a clear advantage, it will be tough for the company to outperform its peers.

What are the economics of the sector or industry?

It's paramount to understand the basic economic principles governing the industry. Who are its customers and what could cause demand for the product to shrink? Knowing the main characteristics of the industry is vital.

For commodity companies, it's important to know the economics of the commodities it they sell. Investors should know what causes an increase or decrease in demand for the commodity.

How well does the company's operations make money?

It's important to understand how well the company's operations can turn a profit. A company could be positioned in a growing industry and in a developing location, but if it struggles to earn money, it won't be a good investment.

Conversely, a company could appear to be in a mature industry, but if it's able to generate positive returns, it could be worth an investment. Take **Canadian National Railway,** for example. The railway industry is a mature industry, but CN is able to generate huge returns on its assets.

Is the company well capitalized?

Understanding the financials is one of the most important things for investors, as problems are one of the top reasons stocks get sold off.

More specifically, debt is one of the most important factors to focus on. Take **Peyto Exploration and Development Corp** (TSX:PEY). Peyto is one of the lowest cost natural gas producers in Alberta. Up until 2018, Peyto's debt never seemed like much of an issue. In comparison to what the company was earning, it was pretty small. Once natural gas prices came under pressure and Peyto began to earn less money, suddenly the debt to earnings ratios began to look worse.

This has resulted in Peyto's stock being halved since the middle of 2018. It's another lesson showing investors why understanding total debt, as well as debt to earnings, is equally as important. It also leads into the next question.

What are all the possible risks?

With every investment, the associated risks are endless. Although you can never eliminate risk, it's critical to understand what poses the highest risk and what probabilities there is that those events happen. Location is important; is the economy of that geography strong and growing? Is there associated political risk? Does the company have interest rate risk?

What's the company worth?

The final and most important question to ask yourself is what you think the company is worth. Now that you have a decent understanding of the business, how it makes money, who it competes against and what the risks are, it's time to put a value on the stock.

Of course, if you believe that the company is worth more than its current price, then you should invest in it. However, it is important to note that if the company is undervalued, it may be undervalued for a reason. If you don't know why the market is discounting it, you should do more research before making your investment.

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2025/08/17
Date Created
2019/05/25
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