2 Important Ratios You Should Look at Before Buying Any Stock

Description

Valuations for a stock can get out of control sometimes. However, over the long term, investors can expect to see things stabilize and return to more normal levels.

A good example of this is the cannabis industry, where valuations have often become obscene, with promises of future growth being enough for many investors to forgive many other shortcomings, including poor market share and little hope for profitability in the imminent future.

It's not surprising that we've seen some of those highly priced stocks fall in value recently. Investors can, however, protect themselves from big corrections in share price by simply taking a look at a couple of important ratios that will quickly help identify if there is a problem with a stock's value.

Price-to-earnings ratio

The first ratio is a very common one, price-to-earnings (P/E). It's an easy one to calculate and serves as a very good benchmark when comparing other companies.

It is calculated by taking the current stock price and dividing it by the earnings per share (EPS) that the company has generated over the past four quarters.

As it involves price, it has the opportunity to fluctuate very quickly, but can help you make a quick assessment of whether a stock is overpriced or not.

Let's look at **Canadian National Railway** (TSX:CNR)(NYSE:CNI) as an example. Over the past four quarters, the company has generated profits of $4.4 billion.

If we divide that by 725 million shares, that gives us an EPS of a little over $6.1. With the stock price around $124, its P/E is a little more than 20.

Value investors might sometimes target a P/E that's 15 or less, although 20 isn't a very high multiple, especially since CN Rail has shown some good growth over the years.

Generally, a P/E of 15 or less is most suitable for stocks that don't have a lot of growth. Tech stocks may often trade at 30 times their earnings, or even higher.

But if you see a stock that's trading more than 100 times its earnings, it's something that warrants further investigation. It could be that the company has had a bad quarter dragging down its numbers over the past year, or it could be a sign that the stock has simply gotten too expensive.

If a company doesn't have any earnings, then obviously a P/E ratio won't be very helpful. This is where we can move on to the next multiple:

Price-to-sales multiple

Using a price-to-sales (P/S) multiple is another valuable tool in assessing value. This calculation involves taking the company's market cap and dividing it by its sales over the past year.

If we go back to CN Rail, the stock has a value of around $89 billion. And over the past four quarters, sales have totaled $15 billion. This tells us that CN Rail's P/S ratio is at around 5.9.

There's a lot more variability here as to what's acceptable, but generally, if you're under a P/S of 10 then that's good. Ideally, however, you'd like to see the multiple as low as possible.

Here again, it would've helped flag high-flying cannabis stocks that were trading more than 100 times their sales.

Bottom line

These multiples can help you get an idea of how much of a premium you'd be paying to own a stock today. It's also helpful when comparing similar investments.

Ultimately, there are many other ways you can assess a company's value, but these two ratios can, at a minimum, help you identify stocks which are grossly overvalued based on their recent performances.

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