Top 3 Signs a Stock is Undervalued

Description

Buying stocks for less than they're worth is the basis of value investing. Long-term value investors, like investment legend Warren Buffett, keep an eye out for companies that have been overlooked and generally mispriced by the market.

However, spotting these undervalued companies isn't easy. Most stocks trade at unbelievably high valuation multiples simply because investors are over-excited about their prospects. Others trade at low valuations because the business is steadily declining and is likely to destroy wealth over time. In short, genuinely undervalued stocks are rare.

Investors must rely on market signals to spot these rare gems. Here are the top three green flags I rely on to spot undervalued stocks.

Low payout ratio

Conserving profits is, in my opinion, one of the most promising indicators of an undervalued company. Managers tend to pay a smaller portion of profits in dividends when they believe they can allocate cash more effectively over the long term. This means the company is likely to create more value over time.

A lower dividend payout ratio also artificially suppresses the dividend yield. Lower-yielding stocks are more likely to be overlooked by passive investors who fail to appreciate the promising economics of these companies.

Alimentation Couche-Tard, for example, offers a paltry 0.55% dividend yield, but is paying out only 9% of earnings and is expected to double profits in five years. Investors don't seem to have priced in this potential growth in both dividends and net income over the next few years, which makes ATD stock undervalued.

Insider purchases

Another great indication of undervaluation is internal purchases. No one understands a company more intimately than its own managers and founders. So, when the senior staff and board members are putting their own money on the line to buy more stock, I believe investors should pay close attention.

At the moment, insiders seem to be betting on **Brookfield Asset Management,** a firm I believe is peerless in Canada's financial sector. The team at Brookfield has earned a reputation for savvy investments, so the fact they're buying their own stock is especially encouraging for investors.

Hidden assets

Underlying assets or subsidiaries are difficult to value, which is precisely why so many investors overlook them. That creates an opportunity for value-oriented investors who are willing to do their due diligence and figure out how much a company is truly worth.

Fellow Fool contributor, Ryan Vanzo, believes he's found an asset on **Just Energy's** books that could be worth three-and-a-half times the entire company's market capitalization. If he's right, the company could be one of the most undervalued stocks on the market and clever investors who got in early could be poised for a massive windfall.

Bottom line

Buying stocks for less than they're worth is a great way to limit the downside risks and magnify long-term returns from your investments. Keep the above three tips in mind when you look for likely candidates.

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