How to Determine if a Stock Is Cheap or Not

Description

One of the most common questions investors ask is if the stocks they're considering cheap. After all, no one wants to pay an expensive price for their stocks.

Here are some of the things you can look at.

Stock type

A commonly used metric to help determine if a stock is cheap is the price-to-earnings ratio (P/E). It's common for new investors to think that stocks with high P/E's are expensive. However, it's not necessarily so. Consider the context of the stock.

The type of stock you're considering matters. Stocks from different industries will have different P/E's. For instance, you can't compare the P/E of a bank to that of an energy stock.

For example, **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) stock would be considered a value stock. It's fitting to use its P/E to help determine if it's cheap or not. You can compare its P/E to its historical P/E as well as its peers'.

At under $83 per share, it trades at about 12.2 times this year's earnings, which roughly aligns with its long-term P/E of about 12.

You would value a growth stock very differently. A growth stock that has high earnings-per-share growth of say 15% a year could trade at a P/E of 30 or higher. However, if it exceeds expectations by growing 20% a year, the P/E can further expand and the stock will go higher. On the contrary, if it grows by only 10%, it will experience P/E contraction and the stock could fall to a P/E of 20 or so.

In fact, some growth stocks don't even have earnings yet. Yet, they can still experience monstrous price appreciation from high revenue growth!

Analyst price targets

For most investors, it's helpful to look at analyst price targets. Generally speaking, it's better to look at the consensus price target. Across many analysts, any bias will be diluted in the consensus target.

There are several things you need to be careful about. First, analyst price targets will change over time as the business or environment changes. For example, when the pandemic hit, analysts cut the price targets to many stocks and lifted them again as the macro environment improved.

Second, analyst price targets may be outdated because of the changes mentioned earlier.

Third, under covered stocks with few analysts' coverage may have a bias price. For instance, a small-cap stock might only have one or two analysts covering it. If they're both overly optimistic about the stock, the price target would be higher than it should be compared to if 10 analysts covered it.

The Foolish takeaway

Determining whether a stock is cheap or not may not be so clear cut. With dividend stocks like TD stock that have quality earnings, it would be relatively straightforward to determine its valuation by comparing its historical P/E to this year's P/E based on normalized earnings.

That is, during the pandemic, its P/E was super high due to an expected drop in earnings. It would be the right thing to do to determine its valuation based on its earnings power in a normal economic environment. If you did that, you would have found the stock to be a bargain last year during the market crash.

Growth stocks' valuations are more unpredictable, especially if their earnings or revenue growth can vary greatly.

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