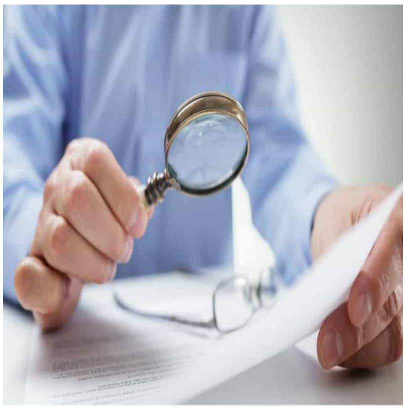

Bear Market: When Are Stocks “Cheap” Enough?

Description

The U.S. stock market is officially in bear market territory by falling more than 20%. So far, the Canadian stock market has lost about 9% from its peak, but it’s still far off from being in bear market territory, as it has been supported by strong gains in energy and other commodity stocks year to date.

In today’s environment, stocks appear to fall most days for an extended period of time. There appears to be no upward price momentum in sight. It seems to be a traders’ market with some stocks rising meaningfully over a day or two before losing those gains quickly. In such an environment, when are stocks “cheap” enough for long-term investors to buy?

Here are some factors that may dictate the level of margin of safety investors need before considering buying stocks.

Earnings quality

The more quality the business and the more durable and predictable its earnings are, the lower the margin of safety investors may ask for. For example, as one of the top 10 North American banks, **Toronto-Dominion Bank’s** (TSX:TD)(NYSE:TD) earnings are durable. In most years, its earnings would rise. Typically, only during recessions, would it experience earnings declines that tend to recover fairly quickly in subsequent years.

Despite the recent stock declines, TD stock has still delivered annualized returns of about 11% in the last 10 years. In the period, it has also increased its dividend at a compound annual growth rate of roughly 9.3%.

At $89.35 per share at writing, it offers a safe yield of 4% on a sustainable payout ratio of about 43%. It trades at a discount of only 4% from the 12-month analyst consensus price target shown on *Yahoo Finance.* This price target is a good gauge. For solid stocks like TD, the price target isn’t likely to change dramatically over time.

For a wonderful business like TD that generates quality earnings and pays a good dividend, investors may wait for a margin of safety of at least 20% before considering buying. This implies a maximum buy price target of about $74.58 per share in TD stock.

For large-cap stocks with more unpredictable earnings but still have solid balance sheets, like **Magna International**, investors may request a minimum margin of safety of 30-40% from the average analyst price target.

Dividends

For stocks that pay little to no dividends, investors may rightly seek a bigger margin of safety of at least 30% as well. After all, even assuming TD stock were to go nowhere over the next 10 years, it would still pay a yield of 4%. That return is stable because it pays a sustainable dividend. Investors rely mostly/solely on price appreciation for stocks that pay little to no dividend. So, it’s only rational to ask for a bigger discount for these stocks before considering buying.

Magna being a Canadian Dividend Aristocrat and pays a higher dividend yield are partly why it commands a higher multiple than smaller peer **Linamar**, despite the latter having a higher operating and net margin. Both stocks are discounted and can deliver strong price appreciation over the next five years.

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