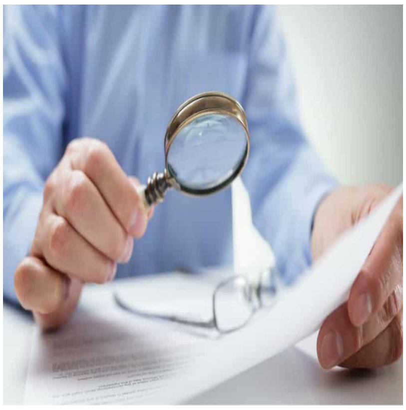

Value Investing 101: How to Find Dirt-Cheap Stocks

Description

If you're into money and personal finance, you might have heard about value investing. Best known as the investing philosophy of Warren Buffett, it has made many investors wealthy over the years. Studies show that value investing tends to outperform growth strategies over the long term. By putting the emphasis on overlooked stocks and long holding periods, value investing spares investors the risks of bubble stocks and the costs of day trading.

So, value investing is a good strategy. The question is, if it's so good, why isn't everybody doing it? The "buy stocks cheap" principle sounds simple; shouldn't everybody immediately go out practice it until there are no cheap stocks left?

Theoretically, yes, which brings us to the main drawback of value investing: the difficulty of finding genuinely cheap stocks. In order to say for sure that a stock is "cheap," you need to know not only that it's cheap compared to last year's earnings and assets but compared to next year's results, too. It's this latter part that trips many people up. Sometimes stocks that look "cheap" are simply going bankrupt. In order to succeed in value investing, you need to find stocks that are both cheap and of high quality. In this article, I will show how that's done.

Step #1: Use a stock screener

The first step to finding cheap stocks is to use a stock screener — a tool that lets you whittle down a big list of stocks to a small one. The screening criteria you'd want to use for a value screen would include

- A price-to-earnings (P/E) ratio: A ratio of how expensive a stock is compared to the profit the business earns. Aim for P/E ratios below 20;
- A price-to-book ratio: A ratio of the stock price to the company's assets, minus debt. Aim for below two; and
- a price-to-free-cash-flow ratio: A ratio of the stock price to the cash a company produces after all expenses and borrowing, paying no attention to non-cash costs. Aim for below 20.

You can add other ratios on top of the ones mentioned above. The point is, screen the universe of stocks for names that are priced low compared to the underlying business.

Step #2: Check the financial statements

Once you've got a list of stocks in place, it's time to check their financial statements. For example, income statement, balance sheet, and so on. These will help you determine if a cheap stock is really a "bargain" or just low quality.

If you look at a stock like **SNC-Lavalin** (TSX:SNC) for example, you'll think it looks cheap at first glance. But when you look at its financial statements, you'll start to see some red flags. For example:

- Its revenue growth is only 4%
- Its net income collapsed in the most recent quarter
- Its day-to-day operations spend more cash than they take in
- The company still lists "litigation settlements" (e.g., having to pay off people who sued them) as a risk factor

SNC-Lavalin has been a controversial company for much of its history. It has been embroiled in many scandals, including one that involved bribing African governments. That's not to say it's not a worthwhile investment, but it goes to show that stocks don't get cheap for no reason. Sometimes, there's ugliness beneath the surface.

Step #3: Double check everything

Last but not least, after you've found a list of value stocks and checked their financial statements, you'll want to double check your work. Make sure you didn't overlook anything in your analysis or forget to read a key financial statement. Value investing is all about safety, and you can't be safe until you've considered all the possible risks in an investment.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:ATRL (SNC-Lavalin Group)

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