3 Things I Look for Before I Buy a Stock

Description

Stock picking is hard. You can analyze a stock to death, learn the company inside out, and sometimes still see sub-par returns. There are no guarantees in the investing world, but by buying and holding great companies over many years, your chances of success are much higher. How does one identify these great companies?

Here are three simple things I look for before I buy a stock.

An industry of need

It's critical that you buy shares in companies that provide a "need" instead of a "want." A company that provides a need increases a company's chances of being around for years to come. Sectors such as utilities, real estate, and banks are a few that come to mind. Steady returns over the long term will not be earned by investing in what's hot today. Boring industries that are proven money makers with recurring cash flows are better long-term bets.

History of earnings growth

Investors should be investing in companies with track records of generating strong earnings. One simple metric I continually look to is earnings per share. I generally look for companies with five-plus years of growth in its earnings per share. There is no guarantee the company can repeat its earning performance in future years, but investors have a greater chance of success buying shares in a company with a proven track record.

Trading at a discount

Buying great companies at a discount creates asymmetric risk, meaning the reward is greater than the risk involved. If investors can find a great company that the market has undervalued, there is a better chance it will eventually return to its actual value with further potential growth.

Two simple metrics I use are the price-to-earnings ratio and the price-to-book ratio. I compare the company's five-year average to the company's current ratios. If the company's current ratios are below its historical average, there is a good chance investors will avoid overpaying for a stock.

A company with all three?

Exco Technologies Limited (TSX:XTC) is an auto parts manufacturer that meets all three of the criteria above. Society is deeply entrenched with automobiles, and vehicles will continually need servicing and new parts; therefore, the company is providing a service that should be around for many years.

The company has exceptional earnings growth as its earnings per share have increased by an annual average of 30.8%. In addition, the company is currently trading at price-to-earnings and price-to-book ratios of 10.4 and 1.8, respectively, both of which are below the company's five-year averages of 13.1 and 2.0. Therefore, investors have reason to believe that Exco is an undervalued company with growth potential.

Foolish bottom line

Obviously, these aren't the only factors investors should consider before acquiring shares in a company. However, by continually seeking undervalued companies with strong earnings in industries of need, you'll be setting yourself up for exceptional returns over the long term.

Fool on!

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