

17. Bear-proofing - key ratios for selecting stocks

Warren Buffett said "I put heavy weight on certainty. It's not risky to buy securities at a fraction of what they're worth". That philosophy comes into its own in a bear market. You want to make sure you **don't overpay for a stock**.

Value investors use a number of ratios to check how much of a value 'cushion' they've got between the value they place on a stock and the price they're being asked to pay for each share. Some of the ratios are listed below. They may look difficult, but mathematically they are easy: you just divide one number by another.

Finding the right figures is a bit more challenging but also quite easy: use a combination of financial web sites, daily newspapers (for market capitalisation), and the company's reports and accounts.

Key ratios

- **Market Cap:Sales** - ideally less than 1
Divide the market capitalisation of the company by its annual turnover
This ratio (sometimes called the Price/Sales ratio or PSR) shows how much you are being asked to pay for each £1 of company turnover. Obviously, the lower the better. Historically, PSR has been useful for predicting future out-performance, especially if the share has shown recent price strength compared to the market.
- **Market Cap:Free Cash Flow** - ideally less than 5
Divide the market capitalisation of the company by its free cash flow, where free cash flow = operating cash flow less tax, interest, and the capital spending required to maintain the company's assets in good condition. Again, the lower the ratio the better.
- **Operating cash flow should be consistently greater than operating profits**
If operating profits are higher than operating cash flow, it suggests that profits are being artificially inflated.
- **Enterprise Value: Profit before Interest** - ideally less than 10
Divide the enterprise value by the pre-interest profits.
Enterprise value is market capitalisation plus debt and minus cash. Comparing this figure with pre-interest profits allows companies to be compared more accurately, without the distortions introduced by different tax rates and differences in their balance sheet gearing.
- **Market Cap:Tangible Book Value** - ideally less than 1
Divide the market capitalisation of the company by its tangible book value
Tangible book value covers assets like cash, property, plant and machinery, and the ideal ratio of 1 or less applies when the company's market cap is no greater than the value of these assets. That's a nice cushion to have as it can prop up the share price effectively. However, avoid companies with high levels of stocks or receivables (unpaid invoices). Stocks may be worth less than their balance sheet value and unpaid invoices may be harder to collect when times are tough.
- **Gearing less than 25% or net cash in the bank**
Divide the company's debt by its equity capital and multiply by 100.
'Gearing' compares a company's debt to its equity capital. Companies with lots of debt compared to their capital are 'highly geared' and are unattractive because they may have difficulty paying the interest due on their borrowings if their operations fail to generate enough cash. 'Low geared' companies (25% or less) are attractive for the opposite reason.

Remember that nothing forces you to be fully invested in shares. So, if you can't find stocks to invest in that satisfy stringent value criteria, it may indicate that the market is still too highly rated.