

How to Choose a Stock

Choosing the right company to invest in may sound like the first step in building a portfolio, but financial advisors say that a beginning investor shouldn't actually "begin" with individual stocks. If you're just starting to build your investment portfolio, buying a single stock is much riskier than buying a low-cost mutual fund that tracks a large group of stocks, and it's more likely that you'll see sharp, sudden changes in the value of your investment if you own just a few stocks.

If you already have a diversified portfolio of mutual funds and ETFs, then you may want to add in a few individual stocks. With the risk of an individual stock, there's also the potential for greater returns: the S&P 500 gained just 0.75% from 2006 through 2010; in the same five years, Apple's stock rose more than 348%. And if you build your portfolio by picking stocks yourself, you'll save some money compared to an investor who pays a fund manager through the fund's expense ratio, to pick stocks.

Keep in mind that when you're buying a stock, you're becoming a part owner of that company. So, short-term market movements aside, the value of your investment depends on the health of the business. Here's more on how to choose a stock:

Buy what you know. Start with an industry or a company that's familiar to you. Here's why:

A place to start. You know why you choose to buy your favorite brands, or how busy the chain restaurant down the street is on a typical night. That's not all the information you'll need, of course, but it may help you put those companies' earnings reports in context.

Avoid the hype. During the dot-com bubble, lots of investors bought stocks without fully understanding how those companies planned to make money. In many cases, it turned out, management didn't fully understand either.

Consider price and valuation. Investment pros often look for stocks that are "cheap" or "undervalued." Generally, what they mean is that investors are paying a relatively low price for each dollar the company earns. This is measured by the stock's price-to-earnings ratio, or P/E. (Find that measure on SmartMoney.com, or calculate it yourself by dividing a company's share price by its net income.) Very roughly speaking, a P/E below about 15 is considered cheap, and a P/E above 20 is considered expensive. But there's more to it than that:

Know what kind of stock you're talking about. A company that's expected to grow rapidly will be more expensive than an established company that's growing more slowly. Compare a company's P/E to other companies in the same industry to see if it's cheaper or more expensive than its peers.

Cheap isn't always good, and expensive isn't always bad. Sometimes a stock is cheap because its business is growing less or actually slowing down. And sometimes a stock is expensive because it's widely expected to grow its earnings rapidly in the next few years. You want to buy stocks that you can reasonably expect will be worth more later, so look at value combined with expectations for future earnings.

Evaluate financial health. Start digging into the company's financial reports. All public companies have to release quarterly and annual reports. Check the Investor Relations section of their web site, or find official reports filed with the SEC online here. Don't just focus on the most recent report: What you're really looking for is a consistent history of profitability and financial health, not just one good quarter.

Look for revenue growth. Anything can happen day to day, but in the long run, stock prices increase when companies are making more money, which usually starts with growing revenue. You'll hear analysts refer to revenue as the "top line."

Check the bottom line, too. The difference between revenue and expenses is a company's profit margin. A company that's growing revenue while controlling costs will also have expanding margins.

Know how much debt the company has. Check the company's balance sheet. Generally speaking, the share price of a company with more debt is likely to be more volatile because more of the company's income has to go to interest and debt payments. Compare a company to its peers to see if it's borrowing an unusual amount of money for its industry and size.

Find a dividend. A dividend, a cash payout to stock investors, isn't just a source of regular income, it's a sign of a company in good financial health. If a company pays a dividend, look at the history of their payments. Are they increasing dividend or not?

www.marketwatch.com/story/how-to-choose-a-stock-1305567953708
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