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Shares and snares

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Choosing your shares is a big step, but it's not unmanageable if you ask the right questions. Gayle Bryant reports. **Gayle Bryant** all articles by this author

YOU'VE decided to make your own decisions about which shares to invest in. But with more than 2000 companies listed on the Australian Stock Exchange, how do you sort out the good from the bad?

Kirsty Dullahide, general manager, investments and strategy, at Australian Unity Investments, says everyone has a different story on how they pick shares, but the first step is to know what type of investor you are.

"You may be happy not to buy shares that rise rapidly during a bull market as long as you are protected when the market turns," she says.

"Also, understand the amount of time you have for investing. This is important as you may love spending every day on the computer monitoring stocks or you may prefer a 'set and forget'-type strategy."

"If you want a 'set and forget' strategy you should perhaps steer towards the low-risk, high-cap stocks that are very liquid and resilient no matter what the market is doing."

You also need to consider where equities fit into the other parts of your portfolio, says Ms Dullahide, adding you need to look at diversification generally.

"For example, if you own an investment property... investing in listed property trusts may not be for you... because that would add more property to your portfolio."

Measures to consider

Researching shares is arduous, so the next step is to apply some quantitative analysis to narrow down the pool.

"One tool you can use is earnings per share [EPS is net earnings divided by the number of outstanding shares]. Historically, this ratio helps show the growth potential going forward," Ms Dullahide says.

Another measure investors look at is yield, but she says there are dangers here.

"A company might say it expects to deliver 10% yield over the next 10 years but you need to look at what is behind the yield. If it is a company with a proven track record and they say they are not going to do anything differently, you can probably trust the figure. This approach would be different to a company that says they are going to be the next Google and they expect to yield 15-20% a year."

Elton Doyle, a director at PPM, says typically companies with a strong yield are good choices as they have no need for cash flow and distribute their profits.

"A high dividend yield also indicates a business is not capital hungry any more – it suggests a strong cash flow," he says.

However, he also advised looking beyond yield and dividends, and to the history of payments.

"A long history of payments means [the company] can sustain the dividend and suggests good earnings strength.

"It is dangerous to buy on dividend yield. You need to understand how much you are paying. We look at the price/earnings (P/E) ratio – and like those that are low or below market."

The P/E ratio is the share price divided by the EPS. It gives you an idea of what the market is willing to pay for a company's earnings. Generally, a high P/E suggests investors are expecting higher earnings growth compared with companies that have a low P/E.

Mr Doyle says the market P/E is about 12 times and if you are paying more, then you are overpaying. Companies with a lot of debt should be avoided.

"Ones with consistent cash flow may be able to service the debt but over the past two years even those companies have had issues," he says.

Equities analyst and investment commentator Roger Montgomery recently published Value-able, a book on how to value stocks. He says when it comes to buying shares, people often take their cue from prices, not the value of the company.

The price changes daily but the value doesn't, he says. "For example, Telstra's share price changes quickly but you can't say that its value changes as fast."

Mr Montgomery feels investors are misled into betting on companies' share prices as they rise and fall, rather than investing in the business.

When choosing shares, he first "turns the stockmarket off" and assesses the performance of the business. Only when he has determined this is good does he "turn the stockmarket back on" and look at what others are willing to pay for the shares.

"You have to think of it as buying pieces of the business. If you aren't prepared to own the whole business for 10 years, then don't buy a piece of it for 10 months."

International shares

There are many generalisations surrounding share buying – one being to avoid global stocks during market turbulence.

"Every generalisation can be proven wrong," Ms Dullahide says. "Sometimes you should avoid global stocks but it depends on the cause of the volatility. With global shares it is not just an equity question but a currency one as well."

Putting it all together

Mr Doyle says when putting together a portfolio you will get most diversity from having 10-12 stocks. Any more is spreading yourself too thin.

"And any one company must not comprise more than 10% of your entire portfolio," he says.

A good source for investors looking to invest in shares, he says, is the Reserve Bank's monthly statement, which gives insight into the domestic economy and to a lesser extent the global economy.

Mr Doyle's final advice is to treat buying shares as if you were buying the whole business, not just shares in it.

"If a GP was buying a practice, they would do all the due diligence required, and it should be the same with buying shares," he says.