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Hunt for bargains: idetentifying bargain stocks

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**INVESTORS are conditioned to look for value in stocks. But how do they identify value? The most common methods are calculating: the price to earnings (PE) ratio, which relates the share price to the earnings stream and costs it; the price to net tangible assets (NTA) figure (sometimes known as price-to-book), which compares the price with the dollar amount of the company's real assets that stand behind each share; and the dividend yield, the return in percentage terms represented by the dividend yield from a share investment.**

The lower the PE, the lower the price to NTA ratio and the higher the dividend yield, the better the value, or so the theory goes.

The problem is that these three ratios are based on the share price.

"If the PE isn't discredited as a valuation tool by now, I'm doing my darnedest to make sure that it is," says Roger Montgomery, independent market analyst.

"Quite simply, the PE doesn't tell you anything. It certainly can't tell you what's cheap or not because price can't tell you anything about value. When you're calculating value, it's got to be completely independent of price."

The other problem with using these three calculations is that they can be low (or high in the case of the dividend yield) for good reason; what may look like underpricing is actually spot-on, and the result is a value trap.

Forward (forecast) PEs also depend on the accuracy of analysts' forecasts for company earnings. If consensus earnings forecasts are too high, you get PEs that are artificially low and completely unreliable.

A rising dividend yield also can indicate a share price in free-fall, which again could be the market getting the stock's future prospects right.

"The market adage states 'Never buy a stock on less than four-times earnings; someone knows more about that stock than you do,"' says Graham Harman, head of investment strategy at Citi. This caveat is more important than usual, he says, with investors rummaging through the market after a 45 per cent rise, looking for value.

"There are sectors like the A-REITs (Australian real estate investment trusts, formerly known as listed property trusts), and infrastructure and some of the industrials, where you can find what look like wonderful bargains: stocks trading at a quarter of their NTA, or three times earnings, or 10 per cent-plus yields. But a lot of them are value traps and you have to know what's going on with the company; there has to be some qualitative assessment, too."

From Citi's lists of S&P/ASX 200 stocks graded on PE, price-to-NTA ratio and dividend yield, Harman has provided a table of the standout stocks, those where a buy rating complements the statistical ranking. But even some stocks rated hold show value on these grounds, he says.

"We've got Paperlinx, for example, trading at 0.4 times book value. Now it's standout value because, if it survives, it's going to be twice the price. We've got Elders trading at less than 20 per cent of its NTA.

"The likes of Fairfax, Austereo, Pacific Brands, Suncorp-Metway, OneSteel, Bluescope Steel and Qantas are all cheap on the basis of price-to-NTA. For some investors, that will be all they want to know.

"Qantas's earnings are in disarray and the stock is on 41 times earnings, but if you assume that it survives, then at some time over the next two years they will return to normal, and you will have bought it for less than it's worth."

On PE grounds, says Harman, once the investor "gets past a whole swathe of property trusts", stocks such as Tower New Zealand, Challenger, Tabcorp and Tatts show up. "Tower is always going to show up there, it's certainly deep value. Challenger is on eight times earnings. Tabcorp is on a single-digit PE; you could ask questions about its business model, but it's not expensive. So I'd be looking in the gaming space, and at financials such as Challenger and Tower."

On a dividend yield comparison, he says, once investors have again dodged all the crippled and impaired REITs, Telstra (9 per cent forecast yield), Premier Investments (10.8 per cent), Tatts Group (9.5 per cent), Telecom New Zealand (8.9 per cent), Goodman Fielder (7.4 per cent), Tabcorp (8.6per cent) and Westfield (7.3 per cent) are the pick of the yield plays, although Citi does not rate all of those as buys.

Elio D'Amato, head of research at Lincoln Indicators, says the PE is the most common determinant of value that retail investors use, but he agrees that it must be backed up with other data, and quality assessments, to avoid value traps.

"Inevitably there are value traps, so you can't just look for single-digit PEs; you're asking for trouble if you only look for that," he says. "But it's also true that outside the ASX 300 -- even outside the All Ordinaries -- you can find some great little businesses, as cheap as chips, that simply go unnoticed by most investors." D'Amato cites the following stocks as classic examples of this group:

**Qmastor (QML)**

QML provides specialist management information systems to the mining, port, power generation and bulk commodity industries. The company lifted its net profit by 33per cent in 2008-09.

**NetComm (NTC)**

NTC provides data communication products for residential, business and industrial markets. It generated an impressive 305 per cent increase in sales revenue over the last year on the back of its 3G wireless broadband technologies.

**Solco (SOO)**

SOO is wholesaler and distributor of solar power and pumping equipment. It posted a record profit of $1.79 million in 2008-09 and announced its maiden dividend. D'Amato expects public policies onrenewable energy to benefit thecompany.

**Austin Engineering (ANG)**

ANG provides engineering products and services for the minerals and energy sector. The recovery of the mining sector should bolster itsperformance.

**Thorn Group (TGA)**

TGA operates in the Australian electrical and household appliances rental market. Thorn increased its revenue in 2008-09 and provides a level of financial certainty uncommon for a small cap company.

It also pays a yield of 6.9 per cent fully franked.

Sven Restel, senior analyst at subscription investment advisory service Wise Owl, says there also is good value to be found in the small and micro-cap sectors of the market. But he cautions that investors can't always use valuation techniques such as PEs and dividend yields because the stocks may not have earnings or dividends.

"We follow the story back to the valuation, not vice versa. We're looking for what the stock will be like in one year, three years; it's the future earnings that are most important," he says.

"If we like a stock, it doesn't have to have a particular single-digit PE or a low price-to-book, it depends on where it is valued relative to its peers. If it has good prospects and is trading at a discount to its peers, it's a bargain."

Being bullish on gold, says Restel, Wise Owl likes emerging West Australian goldminer Silver Lake Resources (SLR), Andean Resources (AND), which is developing the high-grade Cerro Negro gold project in Argentina, and PNG gold and base metals miner Highlands Pacific (HIG). But he also nominates as "standout value" sandalwood producer TFS Corporation (TFC) and second-hand goods trader Cash Converters

"They're all good stories on a combination of good prospects, strong management and good value. They tick all of those boxes.

"But some of them have (negligible) earnings. You can't always use a PE.

"We strongly believe that you've got to drill down and understand a stock's story to really find value."