Finding solid buy-and-hold stocks

Successful long-term trading - investing with the intention of holding a security for one year or more - means paying attention to the big picture, even when a grim short-term outlook sends investors running for the exits. In other words, buy-and-hold investing requires focus, patience and, most importantly, discipline. In order to succeed, investors must avoid getting caught up in violent market swings or other short-term influences, and invest in stocks that they feel comfortable holding for the long term. The article will unfold fundamental indicators that will assist our readers in finding long term stocks.

Fundamental Indicators

Fundamental indicators are among the key tools used in long-term trading. Fundamental analysis is one way to determine whether a stock is undervalued or overvalued. It involves looking at a company's earnings, cash flow and other financial benchmarks (in relation to its industry and to the overall stock market), its historic growth and future growth potential.

Good Fundamental Indicators

There are many financial indicators that can help you determine whether a stock is a good long-term buy. Some of these indicators are stated below.

1. *Price/ Earnings Ratio (P/E)*

   The Price/ Earnings (P/E) Ratio is calculated by dividing the price of the stock by the earnings per share .A company that has a higher Price/Earnings Ratio compared to its competitors or the industry could mean that investors are paying more for every Rupee of earnings, which suggests that the stock is overvalued. A lower number compared to the company's competitors or industry might signal that the stock is undervalued.

For example, if ABC stock has a Price/ Earnings (P/E) Ratio of 8 while the industry has a Price/Earnings Ratio of 12, this suggests that ABC's stock is relatively less expensive compared to its earnings. Conversely, if DEF is trading at a Price/Earnings Ratio of 15 while the industry has a Price/Earnings Ratio of 11, this would indicate that DEF investors are paying more for every Rupee of earnings.

However, these numbers should be considered along with other factors. Some companies or industries that are growing rapidly, for example, will tend to have higher Price/Earnings Ratios due to their higher growth rates. Similarly, when the economy is expanding, a high Price/Earnings Ratio may be acceptable for some types of stocks, particularly those in high-growth industries. When earnings are contracting, a high Price/Earnings Ratio could signal an overvalued stock.

2. *Book Value*

The Book Value is another way to determine whether a stock is over- or underpriced. Basically, Book Value represents what a company would be worth if it stopped doing business tomorrow and was liquidated. The Price-to-Book Ratio is calculated by dividing the current price of the stock by the latest quarter's book value per share. If a stock is selling far below its book value per share, it might be undervalued. Conversely, a stock priced above its book value could be overpriced.

For example, if HIG has a Book Value of Rs20.93 and is trading at Rs10, the stock could be undervalued. However, if QRS has a Book Value of Rs30.95 and the stock is trading at Rs64, this may signal that the stock is overvalued. As with any fundamental indicator, book value must be considered in conjunction with other indicators. It is also more meaningful when used to analyze stocks in certain industries compared to others. For example, the stock of a rapidly growing company could trade well above book value and still represent a good buy in some industries.

These indicators should be taken in to consideration with other indicators in order to make an informed decision.

3. *Cash Flow Vs Debt*

Cash Flow is the amount of money that is moving in and out of a business. Operating Cash Flow is revenue less operating expenses, including adjustments to the net income. Cash Flow is a good indicator of a company's financial health. Hence some investors prefer it as an analytical tool.

Debt is the total amount that is owed by a company, including bonds and outstanding loans. While debt can finance growth during times of prosperity, it can also become a burden if a company is having financial difficulties. A company's debt obligations should be manageable in relation to its cash flow.

4. Dividend Yield

It is a financial ratio that shows how much a company pays out in dividends each year relative to its share price. In the absence of any capital gains, the dividend yield is the return on investment for a stock.

$$\text{Dividend Yield} = \frac{\text{Annual Dividends Per Share}}{\text{Price Per Share}}$$

Dividend Yield is a way to measure how much cash flow you are getting for each Rupee invested in an equity position. Investors who require a minimum stream of cash flow from their investment portfolio can secure this cash flow by investing in stocks paying relatively high, stable dividends.

To better explain the concept, refer to this Dividend Yield example: If two companies both pay annual dividends of Rs1 per share, but the ABC stock is trading at Rs20 while XYZ is trading at Rs40, then ABC has a dividend yield of 5% while XYZ is only yielding 2.5%. Thus, assuming all other factors are equivalent, an investor looking to supplement his or her income would likely prefer ABC's stock over that of XYZ.

5. Price-To-Cash-Flow Ratio

It is a measure of the market's expectations of a firm's future financial health. Because this measure deals with cash flow, the effects of depreciation and other non-cash factors are removed. Similar to the Price-Earnings Ratio, this measure provides an indication of relative value.

Price to Cash Flow=$\frac{\text{Share Price}}{\text{Cash Flow Per Share}}$

6. *Return on Equity*

Return on Equity is the amount of net income returned as a percentage of shareholders equity. Return on Equity measures a company's profitability by revealing how much profit a company generates with the money shareholders have invested.

Return on Equity = $\frac{\textbf{Net Income}}{\textbf{Shareholder's Equity}}$

Net income is for the full fiscal year (before dividends paid to common stock holders but after dividends to preferred stocks.) Shareholder's equity does not include preferred shares.

It is useful for comparing the profitability of a company to that of other firms in the same industry.

7. Profit Margin

It is a ratio of profitability calculated as net income divided by revenue, or net profits divided by sales. It measures how much out of every Rupee of sales a company actually keeps in earnings.

Profit Margin is very useful when comparing companies in similar industries. A higher profit margin indicates a more profitable company that has better control over its costs compared to its competitors. Profit Margin is displayed as a percentage; a 20% Profit Margin, for example, means the company has a net income of Rs0.20 for each Rupee of sales.

The Bottom Line

Successful long-term trading requires a time horizon of one year or more and be willing to focus on the big picture. Investors can use fundamental indicators to determine whether a company is financially sound and if the stock is trading at an attractive price.

It is important to bear in mind that your decision should not be based simply on the fundamental indicators stated above. Such indicators should be read in line with prevailing economic and political conditions in order to make an informed decision.

Source- Investopedia