How To Find The Best Undervalued Stocks
I love stock investing. It’s interesting, exciting and potentially lucrative. It can also be quite risky.

I’ve been investing in stocks for more than 25 years, and over the decades, I’ve learned to identify the factors that push stock prices up, and the factors that can lead to stocks going through bearish phases. In simple terms, value is a good descriptive word for my investment strategy. But what is value?

To me, value refers to potential capital gain opportunity in the stock market. Value stocks are stocks with strong balance sheets, good earnings growth, and low price-to-earnings ratios (P/Es). They’re screened to eliminate layers of risk, so that all that’s left for us is glowing opportunity.

Let’s break that down and look at a value stock’s four components

**Components of a Value Stock**

**Earnings per share (EPS) growth:** Over the medium- and long-term, earnings growth drives share price growth. You definitely want to focus on stocks with earnings growth. Sure, a stock can rise if the company has stagnant or falling earnings—or even annual losses. But the stock that’s most likely to rise is the stock with growing earnings.

My stock selections are expected to grow earnings per share (EPS) by 15% or more, both in the current year and in the next fiscal year.

Investors can look at Wall Street’s consensus earnings estimates to determine EPS growth rates. Caveat: I don’t go by prior years’ EPS. I’m looking toward the future, so I use future EPS.

**Price/earnings ratio (P/E):** I want the stock’s current P/E to be lower than the EPS growth rate. If a company is expected to grow earnings by 18% this year but the P/E is 24, I would consider that stock to be overvalued and I would ignore it. But if the P/E were 12, that would catch my eye!

I’ll also look at the next fiscal year’s P/E compared to next year’s EPS growth rate. There’s no point in buying a stock that’s undervalued based on this year’s earnings, if it’s overvalued based on next year’s earnings. (That situation arises when this year’s earnings growth rate is expected to be quite a bit higher than next year’s earnings growth rate).

There are nuances to the P/E ratio. Many stocks have typical annual P/E ranges, which can provide valuable info on whether the stock is undervalued compared to its normal trading patterns. And industry groups also have typical P/E ranges. One way or another, a stock with a P/E that’s low compared to its normal range, or low compared to its earnings growth rate, is going to be an undervalued stock!
**Dividend yield:** If dividends are important to you, but you also want capital gains, here's a good approach. Add the EPS growth rate to the dividend yield, e.g., 12% + 3% = 15. In that example, you will want the P/E to be lower than 15 when you’re screening for undervalued stocks. If the P/E is 14, I’m not going to get excited about buying the stock. But if the P/E is 11, you’re looking at a good potential capital gain opportunity.

**Long-term debt-to-capitalization ratio:** I focus on stocks with debt ratios below 40%. Simply put, high debt levels can strangle a company’s ability to invest, innovate and compete.

If the stock passes my earnings, P/E and debt screens, then I look at the stock’s chart. I want the chart to be somewhat bullish. I want to buy stocks that appear ready to rise; not stocks that are falling, stagnating, or those that just experienced a huge run-up.

Certainly, there’s an art to reading stock charts. I’m happy to tell subscribers to Cabot Undervalued Stocks Advisor which stocks pass my valuation screens, and what their charts are indicating regarding near-term and medium-term price movement.
About the Expert

Bruce Kaser has more than 25 years of value investing experience in managing institutional portfolios, mutual funds and private client accounts. He has led two successful investment platform turnarounds, co-founded an investment management firm, and was principal of a $3 billion (AUM) employee-owned investment management company.

Previously, he led the event-driven small/midcap strategy for Ironwood Investment Management and was Senior Portfolio Manager with RBC Global Asset Management where he co-managed the $1 billion value/core equity platform for over a decade. He earned his MBA degree in finance and international business from the University of Chicago and earned a Bachelor of Science in finance, with honors, from Miami University (Ohio).