- Investments

What you should look for in a stock

It takes more than luck or intuition to find that perfect investment

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Every share investor will have their own checklist for what they believe makes a good investment. Few companies tick every box, so judgement and common sense are always required. However, here are some of the factors I'd suggest looking out for:

Competitive advantages

This list isn't in order, but if it were, having a competitive advantage would be near the top of the list.

A quality business can usually do things better or more efficiently than the rest. It might have a superior product, a stronger brand, or a cost advantage of some sort.

Healthy and growing profit margins, along with high returns on capital invested are signs of a company with a competitive edge.

A strong financial position

Debt isn't a bad thing, but it must be kept in check. Excessive debt can leave a company vulnerable to a downturn, falling earnings or a tightening of financial conditions.

Companies with more stable earnings can tolerate higher debt levels than those which face higher competition or are more economically sensitive.

Watch debt ratios and look at the maturity profile of borrowings, as well as any covenants.

A sustainable, growing dividend

Many investors are focused on capital growth, but we shouldn't underestimate the importance of stocks that pay you to own them.

In New Zealand, dividends have accounted for over 60 per cent of returns over the past 25 years. Australia isn't far behind at almost 50 per cent and even worldwide, dividends have accounted for more than 30 per cent of returns.

However, don’t simply opt for the highest yield. You’re really buying a growing income stream, not just this year’s dividend. point in buying a company that has no growth options beyond its existing business. A good business will have the potential to grow by expanding its product range, gaining new customers or growing its market.

Look for a company that reinvests a portion of its profits in opportunities that lead to higher future earnings (and dividends).

Strong cash flows

Cash flow is the lifeblood of a business, and most analysts value companies by estimating the future cash flows they will generate in the future. Keep an eye on the cash flow statement and take note of how these compare with headline profits.

Competent leadership

It’s hard to measure but the quality, experience and integrity of a company’s board of directors and management team is very important.

Look for leaders with a clear strategy, who are focused on delivering returns, who treat shareholders (including smaller ones) with respect and who have skin in the game.

Directors should have a range of skills, and it’s crucial that a few have relevant industry experience.

A reasonable valuation

A key driver of your future returns will be the price you’ve paid, and even the best business can become a poor investment if that starting

investors use discounted cash flow modelling while looking at earnings ratios and comparing them to peers, the broader market, and its own historical average.

This is far from an exhaustive list, although the points made here cover some of the most important attributes investors should look for when identifying quality businesses.

Other factors to consider include the quality of assets, whether the company operates in a sustainable manner, and how it might fit within your overall portfolio.

Identifying stocks to avoid is just as important as picking the winners, and while this is equally challenging there are a few warning signs to keep an eye out
for.

Falling margins, a poor track record, stagnant earnings or dividends, and high regulatory risk are a few of these.

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