Aspects to consider in selection of shares to invest in

MOREMI MARWA
moremi@dse.co.tz

Suppose we are looking for a simple common-sense indicator that will inform us that certain shares are relatively cheap and hence may be a potential to buy, most of us wouldn't like to pay more than the value of an asset or item we are buying, right? In my opinion, the first such clue that comes to mind in this process is figuring out what is the lowest point of price of a share relative to the company's earnings that will justify a purchase, also called price earnings ratio (PER).

And just in case we are able to figure out the best PER, what would be other additional criteria, rather similar to the comparison of price that a stock is traded in the market relative to the company's earning capability?

First, consider the financial condition of the company – now, companies from different sectors depict different financial positions, for example companies from the manufacturing or industrial sector will vary in their positions from those in the financial services sector, etc. But let us assume here that we are determined to compare companies from the manufacturing sector. What then will we be looking for that will mathematically and statistically tell us which company to invest in if we are defensive to our investment capital? (a) we may want to invest in a company whose current assets is at least one and a half of its current liabilities, in other words the current assets to current liabilities ratio is more one and a half; also this can be extended into, say (b) company's long term debt obligations should not be more than 100 percent of its net current assets.

Second, consider the earnings stability and/or growth of the company – in this, one has to find out if earnings have been consistently growing overtime and that there are no earnings deficit in a considerable number of years, it is advisable that a coverage period of the five years of earnings stability and/or growth will be a good benchmark. Third, from earnings comes the dividend payment record, it is advisable that one should consider investing in a company that has some record/history of dividend payments. Even though there are academic, and sometime well intentioned arguments about the aspect of dividend payments by the company, mainly because profit distributions versus profit retained within the company has an impact on the future growth of the company, but generally the company that pays dividends, and still maintains a growth history and trajectory is better than otherwise. And lastly is the whole issue of price – as we know it, price is not the same as value. So, for the industrial or manufacturing companies, it is advisable that you consider investing in a company whose price is less than 120 percent of the net tangible assets.

One of the key investment areas in Tanzania is the manufacturing of garments for the global market. PHOTO | FILE

This is to say, if all other matters have been well considered, the price to book value (P/BV) ratio should not exceed 1.2 times. I understand that proponents of the value of intangible assets such as goodwill, intellectual property, etc will argue that the above creation is very simplified because yes sometimes the value of companies can be substantially more than the value of their assets, and/or its shares can trade in the stock exchange at prices that are substantially more than its book value – this is understandable, but only to the extent that goodwill and other intangible assets can be quantified and properly valued.

At this point, one might well ask whether the choice of shares based on the above criterion can be made to be relatively more of a simpler affair than what I have just outlined above – for example is low price/earnings ratio, or a high dividend return, or high assets to price ratio, or large asset value, better criterion than the others? And what about the multiplier effect of low recent earnings, or high dividend returns, or a very long period of dividend records, or a strong financial position, or the current low levels of price of shares compared to previous records. Well, like many good things, they do not come easily and therefore each of these aspects has its importance in analyzing and choosing shares to invest in.

Obviously there is no single aspect or approach to successful investment in shares, there are many ways and means towards becoming successful as long as there is discipline and consistence which are rooted upon careful practices, and as I indicated in the last week's article – the earlier you start this journey the better are your chances to succeed. Understand that it takes a strategic patience to potentially get into the situation of investing only in rewarding companies, but where do you start? By first getting interested in a company particularly when its share price goes down, like where we are now. Lastly, these matters don't start and end with numbers and statistics only. There are qualitative aspects as well such as asking questions as to who manages the company, who participates in the governance of the company, are there significant issues of unjustified executives and staff turnover, etc? What about company values when it becomes to matters of good corporate citizenship, ESG, sustainability, etc?

Mr Marwa is chief executive officer of the Dar es Salaam Stock Exchange
Email: moremi@dse.co.tz