With so many factors to consider and annual reports to pore through, it is often easy to get lost in financial ratios when attempting to identify undervalued stocks. Here are seven common stock market myths.

Myth 1: The lower the Price/Earnings ratio the better

The price/earnings ratio is a useful indicator which shows whether a stock is undervalued. However, it can be very misleading if earnings are boosted (or depressed) by one-off exceptional items. Such items may include foreign-currency gains/losses, adjustments to market fair-value, gains on disposal of assets and profits/losses from discontinued businesses.

Key takeaway: *While a low P/E is generally desirable, to obtain a more accurate stock valuation, the P/E should be adjusted to exclude one-off and non-recurring items.*

Myth 2: The lower the Price/NAV ratio the better

The price to net asset value (NAV) ratio is another indicator of whether a stock is undervalued, relative to the book value of the company's net assets. A high net asset value provides a buffer

for the company against losses during bad times and is also a rough estimate of the breakup value of the company.{loadposition advert1}

However, there are several caveats against over-depending on NAV to measure a company's intrinsic value. Most importantly, book value reflects not actual market value, but the value of the assets as reflected in a company's accounts.

These assets' book value may well be higher than market value if a company bought assets in the past when asset prices had peaked. This explains why stock analysts sometimes speak of a company's revaluated NAV (RNAV) which adjusts book value towards market value.

Occasionally, even after taking into account market value adjustment, a company still trades at a substantial discount to RNAV. This often results when a company's returns on investment (ROI) from capital expenditure is very low, contributing to low profits. In more extreme cases, a low P/NAV coupled with a high P/E would suggest that a company is performing poorly in making good use of its assets to generate returns, or book value well exceeds market value.

Key takeaway: *P/NAV should not feature too highly in investment decisions, unless the company is expected to dispose of some of its marketable assets and distribute a special dividend to shareholders.*

Myth 3: A company with low gearing is in a stronger position than another with higher gearing

Net gearing (net debt to equity ratio) used to be a very good measure of the indebtedness of a company, but with the advent of off-balance sheet financing and alternative debt instruments, it is increasingly difficult to compare between two companies using net gearing.

In recent times, one of the most common ways used by companies to reduce debt is to issue c onvertible bonds
. Convertible bonds are a form of liabilities until bond holders decide to exercise the right to convert them to shares. However, such bonds are not classified as borrowings and are thus not

usually considered in the calculation of gearing.

Key takeaway: *To compare between companies, it is more meaningful to use net gearing adjusted to take into account convertible bonds.*

Myth 4: Dividend yield is a good criterion to select stocks for investments

Although the above generalization is true to some extent, companies' dividends are not always paid out of operating cash flow. Companies routinely make one-off dividends (via so-called "capital reduction exercises") to return to shareholders accumulated surpluses for which the companies have no use for.

In other cases, companies may recommend dividends to be paid with the aim of maintaining share prices, even if they are unable to afford to do so and have to resort using debt to fund dividends. This is obviously not sustainable in the long run.

Key takeaway: *Investors should avoid making investment decisions purely based on past dividends paid, but should check that such dividends are sustainable.*

Myth 5: Companies which announce growing revenues and profits are doing well

It may sound counter-intuitive to dispute the above statement, but a company which announces large revenue and profit increases may not always be telling the whole truth. Press releases often have a way presenting news in a good light.

Some examples of ways in which companies side-step bad news via creatively written press releases include:

- Announcing aggregated revenues and profits from previous quarters in order to mask a

worse than expected results (or loss) from a most recent quarter

- Downplaying the fact that profits were boosted by one-off adjustments
- Neglecting to mention that revenues and profits were boosted by the inclusion of newly-acquired subsidiaries for the first time
- Omitting to highlight earnings per share which may have declined as a result of dilutive share placements, even though total company profits increased
- Reporting a year-on-year increase in profits, but not drawing attention to the fact that profits may have declined drastically quarter-on-quarter

Key takeaway*: Press releases on financial results should always be read with a healthy dose of skepticism. Reading financial statements would give a more complete picture of a company's health.*

Myth 6: Companies with 50% gross margins are doing better than those with 30% gross margins

The above statement is probably true some of the time, but gross margins can vary widely across industries and sectors. A company, by virtue of the industry it is in, could be enjoying 50% gross margins, but may not making supernormal profits. High gross margins are common among companies whose revenues come from rental and chartering income, but such companies usually also face a high depreciation charge on their assets. Even within the same industry, such as offshore and marine, it is not uncommon for vessel owners to earn a 50% gross margin and vessel operators 20%, but for both to have very similar net margins.

Key takeaway*: Gross margins are a useful measure to track a company's performance over time. However, gross margin comparisons between companies are less meaningful, unless one is comparing two or more companies with very similar business models and customer mix.*

Myth 7: It is always a good idea take profits when price has risen

"Taking profits regularly" is an often heard mantra, but it applies mainly to stock traders. Unless a company's fundamentals have changed, investors should not be concern about short term price fluctuations. It is also not realistic for an investor to expect to be able to accurately predict short term market movements.

In a period of growing economic activity, it is generally advisable to hold a stock and ride the wave. By cashing out when a say 20% profit is achieved, an investor may miss out on multi-baggers, stocks that double in price or more over the course of an economic boom.

Key takeaway: *Investors should ride the wave and resist the temptation to sell out when a short term peak is reached. It is generally time to sell only when share prices have retreated 20% or more from multi-year highs.*

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