Newsletter

6 weeks into the Game - what are the leaders up to?

If you’re not in profit you might be looking at the top players who have increased their portfolios by up to $12,000 and wondering what they are up to.

To help answer your question, this fortnight we are taking a look into the trading activity of a few of the leaders as well as some of the most popular stocks traded by the top 10 players.

Top 10 players: It is interesting that out of the top 10 players, we have 5 that have chosen to buy and hold and 5 have chosen to buy and sell and take profits where they can.

The most popular stocks traded by these players include A2M, GXY, NXT and SYR.

An inside look: We have randomly chosen 3 leading portfolios*. In fairness to these players, we have hidden some of the shares they have invested in; however, this doesn’t stop you from seeing the strategy the top players are using. Please remember, that trying to immediately replicate the leading portfolios would be missing the point, as the shares they hold may have already shown their greatest gains.

Player A: This player is buying and selling quite a bit, they have bought 11 times and sold 5 times. They are holding 5 stocks at present including A2M, ALU, NST and two others. In some cases taking profits, but also have not been afraid to sell and cut losses. They have also have chosen to reinvest in a stock after taking profits.

Player B: This player has bought 6 times and sold once at a profit. They are holding 4 stocks at present including A2M, MIN and 2 others. They are holding very little cash.

Player C: This player has chosen to buy and hold. They are holding GXY, KAR and two others. They purchased in August and haven’t sold at all.

You can view player portfolios here. (CSV 2KB)

As you can see the top players are using a variety of strategies. It is important to remember, it is about playing your own game, learning and testing your own strategies and seeing what works for you.

How is your Game plan going? We’d love to hear from you - what lessons you have learnt so far, whether it is from a mistake, something you have tried and it is working well, a book you have found helpful. Email your feedback to share.game@asx.com.au.

* Tuesday 12 September

SIMPLY WALL ST

A deep-dive into relative valuation

In the last two weeks, we looked at how to conduct research on companies and then knowing when to buy or sell a particular company.

In both articles, we spoke about the importance of valuation and we briefly touched on the intrinsic valuation approach, which uses the Discounted Cash Flow model.

The second valuation approach, which is equally as important and commonly used by the investment community is called relative valuation. In this article, we are going to explain what relative valuation is and show you how to interpret the widely-used Price-Earnings ratio.

Since Galaxy Resources is one of the top stocks traded by leaders, we will use it in our examples below. For those that aren’t familiar with the company, Galaxy Resources is a lithium-focused resources company, which explores and mines for lithium. Click here to read more about the company.

The law of one price

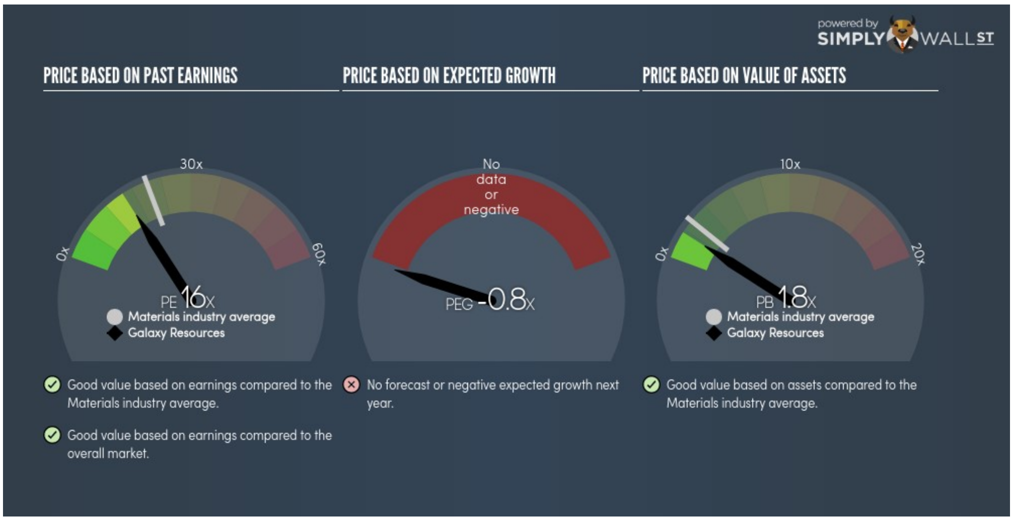
The basic assumption behind relative valuation is the “law of one price”, which says that rational investors will pay the same price for two different assets that have the same risk and return characteristics attached to them.

In stock market terminology, this means rational investors should theoretically pay the same price for the shares in two companies (company A and B) that have near identical businesses. If the value of company A falls below company B, investors have an opportunity to buy A and sell B and vice versa if the opposite occurs.

This is the basic and most important principle behind relative valuation.

Ratios used in relative valuation

There are many different types of ratios that investors use in relative valuation. The three main ratios used in the Simply Wall St application is the Price-Earnings (P/E) ratio, Price-Earnings-Growth ratio (PEG) and the Price-Book (P/B) ratio. Today, we will be focusing on the P/E ratio; however, if you would like to learn more about the other ratios, click here.



The Price-Earnings (P/E) ratio

The P/E ratio is commonly used by investors because earnings power (i.e. the ability to generate profit) is widely considered as a chief driver of investment value. By comparing a stock's price per share to its earnings per share, we are able to see how much investors are paying for each dollar of the company's earnings. In our example, we can see that investors are paying $16.00 for each $1.00 of Galaxy Resources' earnings (or profit).

While knowing that investors are paying $16.00 for each $1.00 of Galaxy Resources' earnings is interesting, the ratio itself doesn't tell us a lot on its own. It only becomes very insightful if we were able to compare it to the P/E ratio of a group of companies very similar to Galaxy Resources. Picking the correct group of companies to compare against is actually the trickiest and most important part of relative valuation to get right.

A quick and easy method of obtaining a peer group for any company would be to use the companies that exist in the same industry, which is what we'll do in our example. In Galaxy Resources' case, we can argue that using the Materials industry as a peer group is valid since all companies in the industry are generally similarly affected by global economic growth, business sentiment and overall commodity prices.

As we agreed upon earlier, according to the law of one price, if we assume that Galaxy Resources is very similar to the rest of the Materials industry, then it should share the same P/E ratio as the Materials industry. Since Galaxy Resources' P/E of 16.0x is actually lower than the industry average of 23.2x, we can imply that investors are undervaluing each dollar of Galaxy Resources' earnings. Therefore, according to this analysis, Galaxy Resources is an under-priced stock.

Formula

Price-Earnings Ratio = Price per share ÷ Earnings per share

P/E Calculation for GXY

Price per share = 2.37

Earnings per share = 0.148

∴ Price-Earnings Ratio = 2.37 ÷ 0.148 = 16x

Some very big caveats

However, before you jump to the conclusion that Galaxy Resources represents the perfect buying opportunity, it is important to realise that our conclusion rests on two big assumptions.

The first is that our peer group actually contains companies that are similar to Galaxy Resources. This is a key requirement of the "law of one price". In our example, we used the Australian Materials industry as the peer group for Galaxy Resources. However, many of you might correctly argue that since Galaxy Resources predominantly mines lithium, it would be incorrect to compare it to companies like Newcrest Mining and Woodside that also exist in the Materials industry but mine for completely different commodities to Galaxy Resources. This argument is entirely legitimate and to address this concern, many investors hand-pick 5 or more companies that they believe are extremely similar to their target company as their peer group, which is a superior approach.

The second assumption that must hold true is the "law of one price" itself. As the law says, rational investors will pay the same price for two different assets that have the same risk and return characteristics attached to them. However, sometimes the stock market is affected by bouts of irrationality, which violates this law and therefore relative valuation as a concept. Think back to events like the tech bubble in the 2000s. During these periods, relative valuation was not an effective means of determining the value of a company.

Conclusion

Now that you understand the assumptions behind the P/E ratio and relative valuation in general, hopefully you feel more confident interpreting and using these metrics. Ultimately, relative valuation is one small piece of the investing puzzle. You should always ensure that the company's fundamentals are solid. To read up about Galaxy Resources' fundamentals, click here.

Game update