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9 Double Bargains for You

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Many investors rely on price-to-earnings (P/E) ratios to decide whether a stock is cheap. But while P/Es can give you a useful starting point, they aren't enough to determine a true bargain by themselves. Only by factoring in earnings growth and other traits can you truly size up a stock's value.

The P/E ratio would be problematic all on its own; the fewer factors you examine, the more you don't see about a company. But beyond that general truth, this metric also has specific problems. Half of it depends on earnings per share (EPS), which companies can sometimes fudge a bit. If they issue lots of extra shares of stock (to raise money or issue to employees) they dilute their EPS. If they buy back lots of shares (to reward shareholders by increasing the value of each remaining share), they give EPS a boost. Earnings can also vary depending on which (legal) accounting methods a company uses.

P/Es also vary widely by industry. Most software companies are rather capital-light businesses, without heavy investments in equipment and factories, so they tend to have a higher-than-average P/E. The automotive industry, meanwhile, is capital-intensive and often slower-growing, and is usually adorned with lower-than-average P/Es.

PEGging good value
The PEG ratio provides one way to incorporate expected earnings growth. You can calculate it by dividing a company's P/E by its five-year expected EPS growth rate. The result isn't a perfect indicator of value, but it has historically helped point to bargains.

I found the following companies in a recent screen for forward PEG ratios less than 1.0, which often suggests an undervalued company:

Company	Forward P/E	Expected 5-Year EPS Growth Rate	PEG
Satyam Computer Services (NYSE: SAY)	10.8	15.0%	0.7
STEC (Nasdaq: STEC)	11.8	55.7%	0.2
Solarfun Power Holdings (Nasdaq: SOLF)	7.8	18.3%	0.4
Ebix (Nasdaq: EBIX)	13.7	15.0%	0.9
Baidu (Nasdaq: BIDU)	40.2	53.7%	0.7
Western Digital (NYSE: WDC)	5.4	6.5%	0.8
Medco Health Solutions (NYSE: MHS)	12.0	17.1%	0.7
China Automotive Systems	14.5	20.0%	0.7
Green Mountain Coffee Roasters	27.6	37.4%	0.7

Data: Morningstar.com.

The PEG's problems

Of course, this metric isn't perfect. It ignores many other useful factors, including debt load, cash flow, profit margin trends, revenue growth, and competitive advantages.

The expected EPS growth upon which it relies can also be misleading; it's just a guess, which could prove to be way off the mark. In addition, EPS growth estimates aren't helpful when a company temporarily has negative earnings, or when you're looking at an established slow grower. If you're using the PEG, proceed with caution.

Digging deeper
Don't rely on the PEG ratio to tell you whether to buy or sell a stock. Instead, use it to help you find candidates for further research.

If you dig deeper into some of the companies above, you'll find that Satyam Computer Services is rebuilding its reputation after an accounting scandal. STEC is a key player in the growing solid-state drive business, but it's been oddly closed-mouthed about its relationship with major customer **EMC**. Western Digital's traditional hard drive business is threatened by the emergence of solid-state drives, but it still seems very undervalued.

Ebix is growing briskly in the generally unexciting insurance-software niche, while Solarfun's appeal combines the promise of solar energy with operations in fast-growing China. Risk-tolerant investors are also excited about Chinese search-engine specialist Baidu, expecting several more years of explosive growth. Medco Health observers like its cash-generating power, but are wary of shrinking profit margins as it competes with rivals.

As you seek compelling stocks for your portfolio, let PEG ratios lead you to worthy candidates.

A few of these growth powerhouses should look familiar to you.

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