The Buffett Guide To Value Investing (Part 3)

This third part of this series focuses on another important element of Warren Buffett's hugely successful methodology - return on equity (ROE). Now, you may have heard the term "return on equity" before. It's not a relatively new concept, and it is one that is commonly used in finance. However, its importance must not be taken for granted.

It's one thing to know what "return on equity" is, while it's another thing to know how to use it to a hugely positive effect. In other words, Warren Buffett uses a tool that is used by basically everyone in the industry, however, he uses it in a way that no one else does, and this is the lesson that all investors should learn from.

First off, I would like to point to the definition of return on equity. ROE is equal to the net earnings of a company divided by shareholder's equity. ROE is also typically associated with the phrase "stockholder's return on investment." It discloses the rate at which shareholders are gaining money on their shares. Whether this rate can constitute a good return or not depends for the most part on the company and sector.

For instance, a low ROE would be regarded as bad for a consulting company since it's in a sector that doesn't necessitate assets to start yielding an income. Then again, a low ROE would be satisfactory and even fine in the oil refining industry because it is an sector that requires numerous pieces of infrastructure to start yielding an income.

Notwithstanding, the type of company or sector is broadly speaking irrelevant in this element of Warren Buffett's methodology (nevertheless, there exists an exception which is outlined in Part One). The reason why ROE is considered very important to him is to verify whether or not a company has experienced a consistent performance well in comparison to other companies in the same industry. The fundamental word here is consistency. Buffett will always favour a company that has a coherent ROE over one that has a ROE that incessantly wavers. In point of fact companies, which ride on commodities such as oil and gas, are by far not his favourites and tend to have for the most part a unsteady ROE. This point is outlined in Part One of this series.

An appropriate time frame for studying the ROE of a company is 5 to 10 years. Such a time frame will give you a sound idea of the historical performance of the company. One way of doing could be opening up past financial reports of a handful of companies, most of which would have their reports uploaded on their website. In addition, it would be useful to research and find the average ROE of a handful of industries to compare company performances.

The next part of this series will focus on another important element of Buffett's methodology - debt/equity ratio, and how many investors frequently overlook it. Stay tuned!

About the Author

Author Martin Sejas is the chief writer of Stocks-And-Commodities.com, a leading stocks trading website dedicated to finding the best and the latest strategies and techniques for stocks and commodities trading. Its mission is to become the 'one-stop shop' on the best stocks trading websites and programs on the Internet.

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