By Christos M. Cotsakos
Chairman of the Board and CEO
E*TRADE Group, Inc.

Study the Basics

Teofilo Olivieri

Everyone wants to know someone who's in the know. You've heard cool investors talk about market caps and P/E ratios. You can too. Most investors look at three basic measurements to determine the fundamental value of any company. Of course, there are plenty more you can look at, but these are the most common ways to get a quick look at a company's worth: market capitalization, earnings per share (EPS), and price-to-earnings ratio (P/E).

Market Capitalization

When we talk about big-cap, mid-cap, and small-cap companies, market capitalization is the figure that measures a company's size and financial strength. Market cap describes the value that investors have ascribed to a given company. It's calculated by multiplying the current price of a stock by the number of shares outstanding on the market. So, if 1 million shares are outstanding and the share price is $50, the market capitalization is $50 million.

In theory at least, the biggest, most powerful market-leading companies will have the largest market capitalization. Accordingly, buying stock in a big-cap company is usually viewed as a more conservative, less risky investment. Buying into General Electric, with a market capitalization of roughly $500 billion, could be viewed as a safer investment than Hybrid Networks, with a market capitalization of around $250 million (roughly 2,000 times smaller).

Earnings Per Share

If you owned a company with three of your friends, you would expect to take home one-fourth of the company's profits. Earnings per share is the same idea: It describes how much income is credited to your piece of a company, that is, what you're going to make as the "owner" of a business for every share you own.

Earnings per share is net income per share of the company's common stock after taxes, depreciation allowances, potential losses, payments to holders of preferred stock and bonds, and other costs have been deducted. If that's too much to remember, think of it as earnings minus some costs divided by the number of shares outstanding. For example, if the company has 1 million shares of common stock outstanding and nets $1 million in a year, its EPS would be $1 for that year. Hypothetically speaking, if you owned 100 shares and the company closed up shop with its $1 million earnings in the bank, you would actually get a $100 slice of the pie from the company. (Assuming the company had no debt or preferred shareholders.)

If the company's EPS is up from the previous year, this may indicate the company's in good fiscal shape with profits on the rise.

Price-to-Earnings Ratio (P/E)

This ratio is used by investors to evaluate whether a stock is overpriced or underpriced—and to project future earnings. It's the current price of the stock divided by its earnings the previous year.

You calculate the P/E ratio by dividing the current price of the stock by its last four quarters per-share reported earnings. If a $50 stock had per-share earnings of $2 in the last four quarters, it has a P/E ratio of 25, which is considered historically to be on the high side.

Price-to-earnings is really a way to compare similar types of companies. Pretend you're bent on buying stock in one of two toy companies. Gizmo Corporation has a P/E ratio of 15, and Toys for Joys has a P/E ratio of 12. Assuming both companies are pretty similar on other dimensions, you would be inclined to view Toys for Joys as less expensive due to its lower P/E and Gizmo Corporation as more expensive, with a higher P/E.

Excerpted from It's Your Money: The E*TRADE Step-by-Step Guide to Online Investing *(Harper Business), by Christos M. Cotsakos.* It's Your Money *is available for purchase through the E*TRADE® Bookstore on www.etrade.com.*