GUARDIAN CAPITAL | PRIVATE WEALTH

PERSPECTIVES

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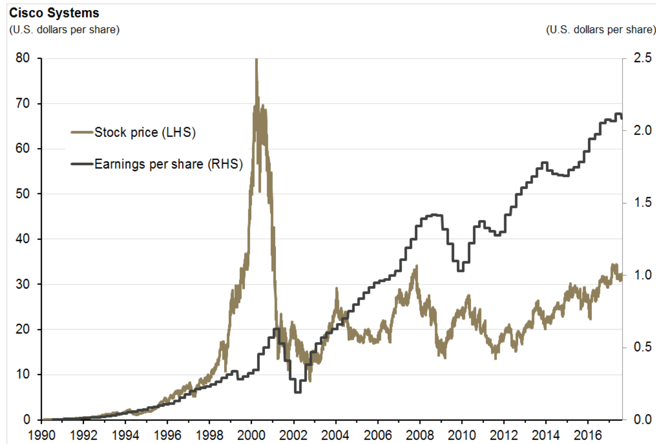
Caveat Emptor

One of the basic tenets of making money in financial markets is to “buy low and sell high”. While this may seem like a simple strategy — buy an asset at a low price and sell it later when the price has appreciated — it is often difficult to put into practice.

One of the main issues is defining the concept of “low”. To know when something is priced “low”, you have to have a very good idea of the asset’s actual intrinsic value; and thanks to various metrics and viewpoints, there is not necessarily one universally accepted definition as to what that intrinsic value may be.



Source: Bloomberg

While that is all part and parcel of financial markets (if everybody thought the same, nobody would ever make a trade), what this type of mentality can beget is a willingness to buy an asset not so much based on how you value it, but because you think somebody else is willing to buy it at a higher price — and again, the goal here is to sell something at a higher price than you paid.

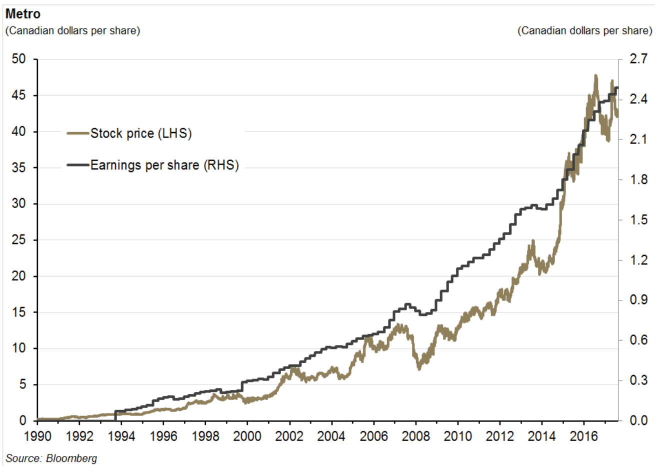
The big concern is that this is how asset bubbles form — investors are willing to pay increasingly higher prices because they believe that there is a “greater fool” out there willing to pay even more (hence this concept being known as the “greater fool theory” of investing).

It is easy to get caught up in this “irrational exuberance”, to borrow from former Fed Chairman Alan Greenspan — you read about a hot stock and chase the market, buying it despite its elevated valuation with the expectation of seeing the price rise even higher. History is replete with examples of why this undisciplined approach to investing ultimately does not pay off.

Take for example Cisco Systems, a darling of the Tech Boom. Unlike many of its peers, Cisco has continued to consistently generate earnings growth over the last 17 years. In the late 1990s however, this stock price became significantly detached from the company’s underlying fundamentals and the price-to-earnings ratio spiked to 230x in March, 2000.

Again, Cisco Systems has proven to be a good company that was able to generate solid earnings growth — indeed, earnings per share have increased at an 11% annual rate since March 2000. If you bought the stock back then, you would still be down 60% on your investment 17 years later!

As a point of comparison, at the same time in March 2000, you had the chance to opt for an investment in the considerably less glamorous business of Canadian grocery retailer Metro. Interestingly, over the subsequent 17 years you would have participated in a comparably strong earnings growth rate (in fact, Metro has grown earnings at a slightly better 13% pace). Because Metro stock, suffering from disinterest as a "non-dotcom", was languishing at 10x earnings at the time, you would not have suffered from the same valuation compression that has punished Cisco investors. In fact, the valuation multiple on Metro has improved moderately since then, with the combined effect of earnings growth and valuation improvement generating a cumulative return of 1,360% over the same time frame.



The bottom line is it is extremely important to remain focused and disciplined in the investment process and not get caught up in the hype surrounding a stock or industry. Investing in a company with strong fundamentals is not prudent if it is done at too high of a valuation. In contrast to what Bob Barker may have told us, sometimes the price is in fact wrong, and buyers must beware.

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