Why You Should Ignore These 3 Common Investing Rules

Description

There's a reason why investing often gets condensed down to one-liners and pithy rules of thumb.

Especially for folks who are first starting out, the world of investing can be incredibly complicated. The basic stuff we take for granted is often far past their realm of understanding. It's not that new investors are dumb; they just don't have the experience.

So, we try to make things easy for them and present the information in a way that's easily remembered. This is where most of the common investing advice comes from: folks like me who are just trying to educate people the best we can.

For the most part, these rules are spot on. They're repeated endlessly because they work. But the world isn't so simple that they should be followed in every situation. Here are three rules that are commonplace that aren't quite as simple as they appear.

Never buy penny stocks

How many times have you heard the experts tell you to stay away from penny stocks?

The reasons for avoiding penny stocks are numerous. Fraud is rampant in penny stocks, especially in companies that don't trade on a major exchange. Penny stocks are often volatile, prone to huge price swings, and don't usually inspire much in the way of confidence. I regularly invest in stocks that trade under $5 per share—which is the new, inflation-adjusted definition of a penny stock—and I'll admit I wouldn't touch 99% of them with a 10-foot pole.

But that doesn't mean they're all terrible investments. One penny stock I own is **Penn West Petroleum Ltd.** (TSX:PWT)(NYSE:PWE), one of the worst-hit victims of oil's decline. The company does have a bloated balance sheet, but it also has had success in selling off assets to reduce debt, even in today's price environment.

Shares currently trade hands at $2.45, even though oil is currently trading at approximately $70 per barrel once translated back to Canadian dollars. If you combine that with drilling costs going down, things aren't quite as bad as they first seem for one of Canada's most beleaguered energy producers.

Never trust a yield of more than 5%

For income investors, a dividend cut is about as bad as it gets. To avoid this, many have a rule that they avoid investments with a yield north of 5%.

The thought process is simple: 5% is a nice round number and represents a pretty good payout, especially in today's world of ultra-low interest rates. It's also the yield where most high-dividend stocks sort of top out at.

But it's also a very short-sighted rule. Does a payout automatically become unsustainable at 5.01%? Of course not. Investors have to look at each company individually, looking at the earnings of each. A stock that only pays out 75% of its earnings will be safer than one that pays out 95%, even if the latter has a smaller yield.

One generous yielder with a very sustainable payout is **Corus Entertainment Inc.** (TSX:CJR.B), the owner of more than a dozen specialty television channels, including Treehouse, YTV, and Teletoon. In 2014 the company earned approximately $180 million in free cash flow, while only paying out $65 million in dividends. That's a payout ratio of less than 40%; very low for a stock currently yielding almost 7%.

Never buy a stock with a price-to-earnings ratio of more than 20

In a search for value, many investors won't buy stocks with what they view as an excessive price-to-earnings ratio. These days, many see 20 times earnings as too much to pay.

But investors who do that need to realize that many sectors don't report the usual earnings. Take **Enbridge Inc.** (TSX:ENB)(NYSE:ENB) as an example. Because of huge depreciation costs, the company is almost guaranteed to trade at an inflated earnings multiple. Currently, according to Google Finance, it trades at more than 122 times earnings.

A better sense of earnings for many companies is owners' earnings, which are simply net income plus depreciation and amortization expenses. If you include both, Enbridge made $3.2 billion in 2014, which puts it at about 15 times earnings. That's a much more reasonable valuation, especially for a company of its quality.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:ENB (Enbridge Inc.)
2. TSX:CJR.B (Corus Entertainment Inc.)
3. TSX:ENB (Enbridge Inc.)

Category

1. Investing

Date
2025/08/28
Date Created
2015/06/10
Author
nelsonpsmith