



Are Airlines Good Investments for Your Portfolio?

Description

Airline stocks have started to grow in popularity over the past few months, leaving investors wondering if the stereotypical view on airline stocks—that they're risky, have low growth and low returns—has changed.

Why are airlines perceived as bad investments?

First, the airline industry, which has been around for nearly a century, hasn't really been a profitable one for vast parts of its history. While there are cycles of growth where huge profits can be made, most of the time, airlines break even or worse.

This was echoed nearly a decade ago by Warren Buffett in a letter to investors, where he noted, "The worst sort of business is one that grows rapidly, requires significant capital to engender the growth, and then earns little or no money. Think airlines."

To put this into perspective, think of an airline that is trying to expand. Planes can cost upwards of \$80 million each. Planes also require highly specialized ground crews, flight crews, and mechanics, the vast majority of which are unionized. I'm not even mentioning maintenance costs, which increase as planes get older, or ongoing fuel costs.

Finally, airlines are very receptive to the overall health of the economy. When a recession or market downturn hits, often some of the first things that businesses and individuals cut from their budgets are travel expenses.

In short, you are left with a high-risk, expensive business that cycles through high-growth or boom periods, only to be followed by periods of contraction and prolonged losses.

Why are we seeing more investments in airlines?

Part of the reason for the growing popularity of airline stocks is because we are in one of those periods of rapid growth, which has attracted a lot of investment interest.

Chief among them is, ironically, Warren Buffett's **Berkshire Hathaway**. Berkshire has invested in four of the largest U.S. carriers: **American Airlines Group Inc.** ([NASDAQ:AAL](#)), **Delta Air Lines, Inc.** ([NYSE:DAL](#)), **United Continental Holdings Ltd.** (NYSE:UAL), and **Southwest Airlines Co** ([NYSE:LUV](#)).

United and American Airlines are up over 60% in the past six months. That's an incredible amount of growth over a relatively short time, and the skeptic in me doesn't see that level of growth lasting much longer.

Air Canada ([TSX:AC](#))(TSX:AC.B) and **WestJet Airlines Ltd.** (TSX:WJA) are also subject to this growth cycle which is industry wide. Air Canada is up over 50% in the past six months, and WestJet is edging close to 10% in the same time.

Are airlines good investments?

Historically, my opinion would be to stay away from airline stocks because of the nature of their business cycle. However, one aspect that has caught my attention of late has me reconsidering that decision.

During this growth cycle, we've seen airlines expand, but at a gradual, if not modest, pace, which is in stark contrast to the massively expensive boom periods of the past. By keeping that growth modest, airlines can keep expenses in line and shore up cash flow for the eventual down period.

By way of example, American Airlines is undergoing a massive fleet renewal, but the airline is gradually rolling out that new fleet over time, which keeps costs in line. The same could be said of United's new Polaris lounges and upgraded seating. Keeping in line with that modest growth mantra, the airlines are also forecasting lower growth levels for next year.

Similarly, WestJet's roll-out of trans-Atlantic service to the U.K. from multiple cities on new planes was more akin to the expensive boom periods of the past and was met with growing pains and strains on results.

Perhaps Berkshire Hathaway is really on to something here.

CATEGORY

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