What Canadians Can Learn From Chipotle Mexican Grill, Inc.

Description

Last week, Canadians have had a front-row seat to watch the troubles of American restaurant company **Chipotle Mexican Grill, Inc.** (NYSE:CMG). The problems for investors go far beyond simple food preparation to something much more troublesome.

When a stock becomes the new "hot stock," it is not uncommon for the growth story to become explosive and for investors to be willing to pay a higher multiple for shares of the company. In the case of this burrito giant, the trailing price-to-earnings ratio is still an astonishing 105 times earnings in spite of shares declining by almost 13% last week and by 17.5% for the month.

As is the case for many companies, what started out as an amazing growth story eventually soured, and investors paid the price. Midway through 2015, shares traded near the US$750 mark only to fall to almost US$350 the year after. Friday's closing price was no more than US$344.50 as shares lost another 3% for the day.

The trap that many investors fall into when investing in hot stock is that everything that can go well is, in fact, going well. It's similar to the "hot hands" fallacy in basketball. When a player makes 15 shots in a row, it is highly likely that he/she will make the next one, but it is not guaranteed. Investors, however, assume that it is a guarantee.

For Canadians, there are many examples of this. A generation ago, the gold company Bre-X was a "Canadian gem" whose momentum pushed the share price into the stratosphere. After that, it was Nortel Networks (Northern Telecom), which went to almost $125 per share before crashing and going bankrupt.

In recent memory, it was **BlackBerry Ltd.** (TSX:BB)(NASDAQ:BBRY). The company was the "it" stock that made many Canadians rich and then subsequently traded for less than $10 per share. Currently priced at close to $12.50 per share, the company is returning to the starting point of servicing business clientele and staying out of the limelight.

The problem with Chipotle is the way investors behave towards the perceived "potential." When investors consider securities to add to their portfolios, it is critical to understand the stage of growth the company is really in. In many instances, Canadian investors fail to realize that many of the hottest stocks (at least in the short term), are high-growth stories that often do not work out as expected. For long-term investors, what begins as an intention to hold an investment as maybe 5-10% percent of the portfolio can grow to more than 20% of the total.

Unfortunately, as many have experienced in the past, the fantastic run of younger companies full of promise does not necessarily end in profit; instead, in many cases, it reverses course, and what has become a major holding for many investors turns into a major loss.

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