Why Great Companies Can Be Bad Investments

Description

Most investors would agree that **Fortis Inc.** (TSX:FTS)(NYSE:FTS) and **Canadian National Railway Company** (TSX:CNR)(NYSE:CNI) are great companies. Both have a long-term track records of growing their profitability and dividends. However, they can underperform in the near term.

When you shop for groceries at the supermarket, price is what you pay and value is what you get. Shopping for companies on the stock market is the same. In either case, you want to get good value for your buck.

Fortis

The diversified North American utility is a great company. In the last 17 years, Fortis has been profitable, and there's no doubt that the trend will continue.

Fortis's largely regulated business allows its earnings and cash flows to be very predictable. In the last 17 years, the utility only had five years in which it experienced earnings declines. And in four instances, its earnings more than recovered in the following year.

Fortis's stable earnings and cash flow generation have allowed the company to become one of the top dividend-growth stocks publicly available in Canada. Specifically, the stock has hiked its dividend for 43 consecutive years. Its five-year dividend-growth rate is 5.6%, and its quarterly dividend per share is ~6.6% higher than it was a year ago.

With a payout ratio of ~67% and confidence in the company's stable growth going forward, management anticipates it will grow its dividend at a healthy pace of, on average, 6% per year for the next few years.

Canadian National Railway

Canadian National Railway operates Canada's largest railroad network with ~19,600 route-miles of tracks, offering connections to three coasts. It is one of the most efficiently run railroads in North America, posting a low operating ratio of 55.9% last year.

Canadian National Railway plays an essential role in the economy, as it transports ~$250 billion worth of goods annually. Last year, its major revenue sources were intermodal (24%), petroleum and chemicals (18%), grain and fertilizer (17%), forest products (15%), and metals and minerals (10%).

Similar to Fortis, in the last 17 years, the leading railway has been profitable. In that period, Canadian National Railway only had one year in which it experienced an earnings decline, but its earnings more than recovered in the subsequent year.

Canadian National Railway's double-digit growth rate over the years has allowed the company to hike its dividend for 21 consecutive years. Its 10-year dividend-growth rate is 16.5%, and its quarterly dividend per share is 10% higher than it was a year ago.

With a payout ratio of ~34% and its earnings expected to grow at least 8.5% annually, the railway has the ability to grow its dividend by at least 8.5% per year for the next few years.

Investor takeaway

I've painted a great picture for the high-quality stocks. Unfortunately, quality comes at a price. Most of the time, Fortis and Canadian National Railway trade at a premium.

Their earnings per share are estimated to grow at rates of ~6% and ~8.5%, respectively, while their shares trade at multiples of 18.6 and 21. At best, investing in these stocks today can match the market performance. At worst, they'd underperform.

In summary, investors should look for a reasonable margin of safety before buying even quality businesses such as Fortis and Canadian National Railway.

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