Why You Shouldn’t Speculate When Investing in Stocks

Description

A friend of mine has invested in small-cap mining stocks and marijuana stocks because they believe that investing in stocks is all about speculation. Their line of thought is that share prices are unpredictable.

They believe that by buying into the momentum when a stock is going up, they can make money. However, their portfolio results say the opposite. Roughly 90% of their holdings are deeply in the red.

Now, I don’t know how long they have held those stocks for, but I believe there must be a better and safer way to make money when investing in stocks.

I agree that share prices are unpredictable in the short term. However, speculating doesn’t help in the end result. On the contrary; strong fundamentals allow for price appreciation in the long run.

How to not speculate

If there’s only one thing investors should look at, it would be to check if a business is profitable, which is indicated by positive earnings.

A consistent record of growing earnings is even better because it means the company is capable of growing its profitability over time.

Take a look at growth stocks **Alimentation Couche Tard Inc.** (TSX:ATD.B) and **Boyd Group Income Fund** (TSX:BYD.UN) as examples.

Couche Tard has increased its earnings per share (EPS) by 245% in its last five fiscal years, which is a rate of ~28% when compounded annually. Boyd has boosted its EPS on average ~18% per year for a total of 131% from 2011 to 2016.

Most of the returns from these two stocks come from share price appreciation. In the above periods, Couche Tard's and Boyd's annualized returns were ~32% and ~48.7%, respectively.

It's essential to note that Boyd's price-to-earnings multiple has expanded from nine to 30, while Couche Tard's has expanded from 17.4 to 20.3 in the last five years or so. As a result, buyers today shouldn't expect those monstrous returns going forward.

At ~$60 per share, Couche Tard trades at a forward multiple of ~18 and is expected to grow its EPS at a rate of ~14% for the next three to five years.

Boyd trades at a forward multiple of ~27.4 at ~$97 per share and is expected to grow its EPS by ~20% per year on average for the next few years.

Looking at their near-term estimated growth rates, Couche Tard is a better value.

Investor takeaway

I can understand why certain investors use a small percentage, perhaps, 5% of their stock portfolio, for speculative investments that are intended to achieve monstrous short-term gains.

However, I believe investors would be doing themselves a disservice if they speculate with a big part of their portfolios. In fact, a good exercise would be for investors to track the returns of their holdings over time and stop doing what's making them lose money and do more of what's allowing them to make money.

I think they'll find that if they, at the very least, focus on businesses that show consistent profitability, their portfolio returns will greatly improve.

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