What Makes a Safe Stock Safe?

Description

For most of the last decade, the market has valued **Fortis Inc.** (TSX:FTS)(NYSE:FTS) at a high price-to-earnings (P/E) multiple. Its normal P/E in that period was nearly 19. So, most of the time, investors paid a high multiple in exchange for the diversified utility's safety and stability.

As safe an investment as Fortis may seem to be, the stock has declined more than 17% from its recent high in late November. Is the stock no longer safe? What made investors think Fortis was a safe stock to begin with?

A safe business generates stable earnings

Fortis is perceived to be a safe stock because it has demonstrated its ability to generate above-average, stable earnings over the long term. For example, if you graph the company's earnings per share every year for the last 20 years, you'll see that they form a general uptrend with small bumps along the way.

Over the years, Fortis has built an economic moat and has become one of the top 15 utilities in North America. Further, it has a reputation for its safe, growing dividend. In fact, it has increased its dividend for more than four decades! Only one other public Canadian company has achieved that feat.

Fortis generates more than 90% of earnings from regulated assets and generates roughly 60% of its earnings from the United States. Years down the road, people will still be using gas and electricity from Fortis. So, the company will still be around as the "Steady Eddie" business that it is.

The business is "Steady Eddie," but the stock hasn't been so as of late.

Is a stock safe? Look at its valuation

In an increasing interest rate environment, which is the environment we're in, companies with lots of debt will be pressured. Fortis, including many other utilities, are just some of the companies that are under pressure.

Higher interest rates will dampen the growth of Fortis and other debt-heavy companies. That's why we're seeing multiple contractions in these companies. However, eventually, these stocks will be so cheap that the market will start bidding them up again. They're not quite there yet.

How cheap is cheap? It's hard to say. In the last recession, Fortis traded as low as a P/E of 14.2. Currently, at $39.70 per share, Fortis trades at a P/E of about 15.6.

When investors buy Fortis at a full valuation, they are essentially accepting the potential downside risk. Some of it has played out in the last two months or so. If Fortis had remained fully valued, it could still have delivered roughly market returns.

Investor takeaway

Some investors view safe stocks as companies with stable, growing earnings. However, investors need to do their part by paying an attractive valuation for stocks. Depending on the valuation investors pay, investors should be prepared for the different returns scenarios that can unfold. Next time such stocks are fully valued, will you take profits?

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