How Quality Stocks Can Be Dangerous Investments

Description

Ideally, investors want to fill their diversified portfolios with quality stocks. There's no doubt that **Canadian Apartment Properties REIT** (TSX:CAR.UN), **Andrew Peller Ltd.** (TSX:ADW.A), and **Richelieu Hardware Ltd.** (TSX:RCH) have been excellent stocks recently. However, it can be dangerous to have these stocks in your portfolio when they're excessively expensive.

What might quality stocks look like?

Canadian Apartment REIT, or CAPREIT, stock has performed well. Since it was reasonably valued in the summer of 2013, the stock has delivered returns of 16.6% per year.

Andrew Peller stock has been extraordinary. Since the breakout in July 2015, the stock has delivered returns of more than 40% per year.

Since late 2012, when Richelieu stock traded at a reasonable multiple, it has delivered annualized returns of as high as 25%.

Notably, the run-ups of these stocks have been supported by growing profitability on a per-share basis — at least initially. As more investors jumped in to the stocks, their share prices moved higher until the stocks became excessively overvalued and the momentum was lost. And that's where the danger lies.

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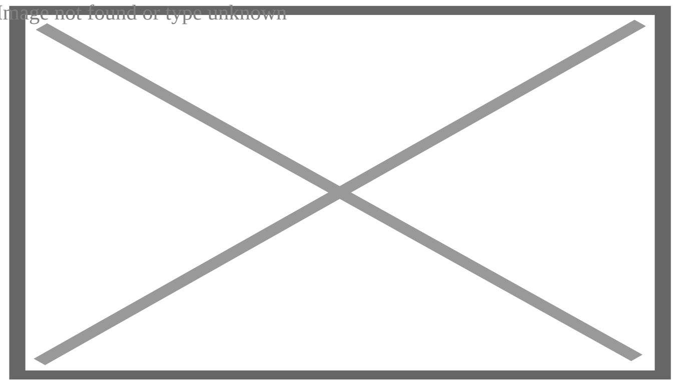

The danger

A big portion of CAPREIT's gains come from the stock trading at a premium multiple.

At about $43.20 per share, CAPREIT trades at a price-to-funds-from-operations ratio of nearly 23, while the residential REIT is estimated to grow its funds from operations per unit by about 4% per year, roughly in line with the long-term inflation rate.

The fact stands that the incredible stock remains strong, and no one knows when the market will realize how expensive the stock is. Perhaps a sell-off will be triggered at one point by bad news in the residential real estate market.

Although Andrew Peller stock trades at a multiple of about 23, it has been experiencing higher growth than CAPREIT. In fiscal 2018, its organic sales growth was 5.4%, while its winery acquisitions in late 2017 seem to have boosted the company's return on equity, leading to earnings-per-share growth of 11% for the year.

In Andrew Peller's recent document, it stated, "Currently, the company has an estimated 14% share of total volume of the wine market and a 37% share of total volume of the domestic wine market, with the company's Peller Estates brand the top?selling wine in this market."

The company has a clear position in the wine market. However, consumer tastes can change. So, it'll need to think of ways to maintain or even expand its market share.

Andrew Peller stock has experienced weakness in the last week. Only time will tell if this is the start of a sell-off.

Richelieu stock was excessively expensive in late 2017, and that's why the stock has underperformed year to date by falling about 18%.

Investor takeaway

The three examples discussed here are very different businesses. So, they cannot be compared directly. What they have in common is that their share prices have had a run-up, which was at least initially supported by growing profitability.

However, at one point, the share price gets ahead of the company's growth, and when the market realizes that the stock has become excessively overvalued, we could see a sell-off (and we've started seeing this in Richelieu stock), and that's where the danger lies.

No matter how high quality a business is, investors should be cognizant of how much they're paying for a stock. If you pay too high a multiple for stocks, your returns will suffer.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

1. TSX:ADW.A (Andrew Peller Limited)
2. TSX:CAR.UN (Canadian Apartment Properties Real Estate Investment Trust)
3. TSX:RCH (Richelieu Hardware Ltd.)

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Date
2025/07/26
Date Created
2018/07/03
Author
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