How to Spot the TSX Winners That Keep on Winning!

Description

Many Canadian value investors tend to be reluctant to scoop up **TSX** stocks that are at or around their 52-week highs. And stocks at fresh, new all-time highs? Many value-conscious investors may be inclined to wrongfully shun them, as their valuations are likely to be on the high side of their historical averages.

While it's good to pay careful attention to the price you'll pay for the merchandise you'll get, value investing is not as simple as buying cigar-butt stocks that sport low price-to-earnings (P/E) or price-to-sales (P/S) multiples. Without a careful evaluation of the underlying business, one could stand to scoop up a value trap of a stock that could leave investors holding the bag with continued losses.

Just because a stock looks "cheap" doesn't mean it's undervalued and vice-versa

Remember, just because a stock is cheap based on its historical valuation metrics does not mean it's undervalued. And the reverse is also true. Just because a stock is on the pricier end of its historical P/E or P/S spectrum does not mean it's overvaluation or overdue for a pullback. There are certain classes of winners out there that can and likely will continue winning.

Now, I'm not suggesting that you change your investor style from value-oriented to momentum-based. Rather, I'm driving home the point that traditional valuation metrics such as the P/E or P/S don't tell the whole story. Stocks at 52-week (or all-time) highs with high multiples should not be shunned solely on arbitrary metrics.

Sure, by shunning the names on the latest 52-week high list, you could stop yourself from following the herd into a sexy play or a bubble. But by doing so, you could also be leaving seemingly expensive stocks that may actually be undervalued relative to that of their forward-looking growth trajectories. Although it's challenging to value fast-growing companies with a new set of tailwinds, investors are doing themselves a great disservice by assuming recent winners are due to be the next losers.

The “winners keep winning” philosophy may be subscribed to by momentum traders and speculators. But what separates them from value-conscious growth investors is the homework and analysis done to determine if the premium price tag justifies the trajectory to be had over the next 3, 5, or event 10 years. A high-P/E growth stock at a new all-time high could very well be an incredible value if the price of admission doesn’t fully reflect the discounted cash flows to be had over the longer run.

As Warren Buffett’s right-hand man Charlie Munger put it best, “All investment *is* value investment in the sense that you’re always trying to get better prospects that you’re paying for.”

Shopify: An “expensive” stock that was severely undervalued

Consider a high-flyer like **Shopify** (TSX:SHOP)(NYSE:SHOP). The name was always “expensive,” with its double-digit P/S. Back when the stock crumbled like a paper bag amid the February-March 2020 market crash, I noted that Shopify stock was undervalued despite its lofty 20x sales multiple, given the firm was likely to be one of the few beneficiaries of the COVID-19 pandemic.

I also noted that Shopify, although expensive based on its traditional valuation metrics alone and its lack of profitability at the time, that its stock was unlikely ever to become anything short of absurdly expensive. Moreover, I noted that even value-conscious investors should buy the name as Shopify shares, I thought, had the potential to become more expensive over the coming months, given the new set of tailwinds and the amped-up growth potential that were unrecognized by most at the time.

If you subscribed to the traditional value investor mindset (which is more akin to that of a cigar-butt investor), you stayed on the sidelines with a name like Shopify because of its absurd valuation metrics, which gave the illusion of an overvalued stock when it was, in fact, severely undervalued, given the unappreciated and unrecognized near- to medium-term growth trajectory behind the name.

Foolish takeaway

If you wish to own TSX winners that keep on winning, you must weigh the price you’ll pay for what you’ll get. Focus less on arbitrary factors such as past price movements and treat traditional valuation metrics as just one of many pieces of the valuation puzzle.

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Author
joefrenette