Caution: 1 Misconception About Stock Investing You Must Know

Description

When choosing which stocks to invest in, investors often look at the past performance of the stocks to determine if they're good buys. While this observation can be useful, investors should be careful on how they interpret this information.

A dividend stock example

For example, **Fortis** (TSX:FTS)(NYSE:FTS) stock delivered annualized returns of 10.3% in the past 18 years, turning a $10,000 investment into $58,784.

More than a third of the returns came from its dividends. During that period, it increased its dividend every year. The 10.3% beats the long-term average market returns.

Some investors look at this information and come to the conclusion that Fortis stock will continue to beat the market while paying a safe dividend. However, there are more details to dig through.

At the start of the period, Fortis traded at a price-to-earnings ratio (P/E) of approximately 13. Today, its P/E is close to 20. That said, it makes sense that the utility has a higher multiple today, because it's higher quality with a bigger scale and a more diversified business.

Given the company's projection of a 6% dividend-growth rate over the next five years, it's safe to assume that it'll grow its bottom line at approximately that rate as well. So, the stock is pretty fully valued on a P/E of 20.

Assuming the regulated utility stock is able to maintain this premium valuation, the 6% growth rate and 3.8% dividend yield can deliver returns of about 9.8% per year.

This estimate is close to Fortis's long-term returns, because it's a predictable business with little uncertainty. If you can buy it on dips (at a P/E of 18 or less), you can push for annualized returns of about 12%.

Fortis's dividend is safe — not because of its track record of dividend increases, but because of its stable earnings and sustainable payout ratio of about 75%.

A growth stock example

Shopify (TSX:SHOP)(NYSE:SHOP) stock is incredible. There's no doubt about it. Since its initial public offering in 2015, the growth stock has climbed 3,756%.

To get a sense of how big Shopify has become, let's review its global sales on the recent Black Friday/Cyber Monday weekend. Sales were +US$5.1 billion from the more than one million Shopify-powered brands around the world, up 76% from +US$2.9 billion in the prior year.

More than 44 million consumers purchased from independent and direct-to-consumer brands powered by Shopify — a 50% jump from 2019. Consumers in Japan and Australia spent the most on average, while the top-selling cities were New York, Los Angeles, and London.

Shopify is still growing at a fast pace with revenue growth of 73% in the last 12 months. However, it's a much bigger company than it was five years ago.

Importantly, the stock has been bid up. Shopify stock trades at an enterprise value to next 12-month sales of 34.5 times today versus 6.9 times from five years ago. Therefore, it's more rational to expect that the growth stock's returns won't be as good over the next five years versus the last five.

The Foolish takeaway

While it's useful to look at a stock's past performance, it's important to be rational about the stock's future performance. Generally speaking, if a stock has delivered excellent returns in the past, it would likely continue delivering at least good returns going forward — given you buy the stock at a reasonable valuation and management continues to do its mojo.

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