Wealth Management
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Cooper Wealth Management of
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Thoughts on the market

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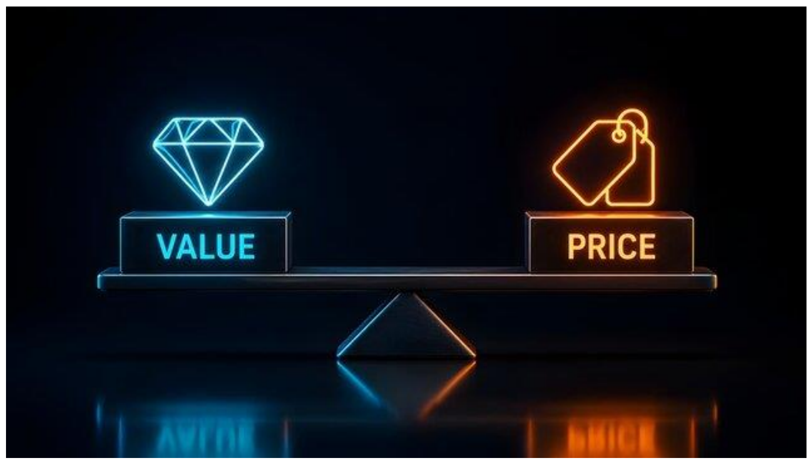
Price vs. Value



“Price is what you pay. Value is what you get.”

- Warren Buffet
Berkshire Hathaway

In today’s capital markets, the price of stocks can swing widely based on expectations made or missed or overblown optimism or panic selling. The true measure of the value of a company is gauged by cash flow and the ability to compound earnings over time. This month, we will explore various sectors of the market and discuss stocks of true value versus those we believe to be overhyped to offer an insight into the equity selection process for your portfolio.

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We will start with technology, where we believe the widest differences in valuation exist. To illustrate the difference between value and speculation, let's compare SpaceX/Tesla and Microsoft. Tesla has delivered tremendous returns over its history but over the last 5 years has delivered a 12.8% compound return versus the Nasdaq Index return of 19.09%. Tesla took EV sales to new heights but competition from both China and the traditional auto makers has led to slowing sales and narrowed profit margins. The company is currently pivoting towards self driving robo-taxis and humanoid robots. Elon Musk has turned science fiction into science fact before, but we are unwilling to pay an eye popping 306 times current earnings for the stock today. The case for SpaceX is even less compelling. SpaceX has led major innovations in rocket launching and satellite communications. They are also developing their own artificial intelligence model. Despite these breakthroughs, they have yet to discover how to make a profit. While they managed to reduce losses on their second quarter, anyone buying the shares now is paying for earnings that could be years away. At this stage, you are paying for Musk's reputation and overpaying for the shares. By contrast, there is Microsoft, which has averaged a 20% compound return over the last 5 years and just reported quarterly earnings of $90 billion, making to the most profitable company on the US at the moment. It trades at 26 times earnings, which is in line with its long-term average. Their Azure Cloud computing division is growing at an amazing 37%. The stock had been weak this year until the recent quarter when the stock rallied from the June low of $373 to the current price of $506. Strong growth at a reasonable price with consistent earnings make a winning combination and worth waiting out any market weakness.

The latest US quarterly earnings reports have come in strong amongst multiple sectors with 86% of companies beating expectations. The big concern coming into this reporting period was that US GDP had slowed to 1.5% and given the elevated inflation rate, there were concerns that US consumer spending was slowing down. These concerns were reflected in the price of Mastercard shares, which hit a June low of $471 but after a robust quarterly report, the stock has rallied to $563. The Mastercard earnings helped financial stocks on both sides of the border, as market leaders such as our portfolio holdings, JP Morgan and Royal Bank, have added a further 10% to their share prices since the start of June. The financials have historically been an excellent source of compound growth with the notable exception of 2008.

We also believe it is important to avoid distractions when considering stock valuation. The first, and often largest, distraction is politics. Much of it is merely noise and does little to affect business and consumer spending. War, however, is a different matter. It tends to lead to an extended period of inflation and in this case, higher oil prices. While oil stocks could see some sell off with a peaceful settlement, we believe oil stocks will continue to see strong profits, even if the oil price falls back to the pre-war $70 level. Companies such as Suncor and Canadian Natural Resources are currently compounding these excess profits, making them even more attractive investments moving forward. The other issue it creates is a higher US dollar. At $1.40, we believe the US dollar is at the high end of its traditional range versus the Canadian dollar. In a more peaceful time, we expect to US dollar to pull back to the $1.25-1.30 range but given US profit forecasts, we expect US equity to outperform the currency drag.

The other great distraction is investor sentiment. When the market decides it doesn't like something, or likes it too much, group think takes over and everyone rushes in or out. That is where careful analysis of the underlying numbers is the only way to avoid a bad decision. Market settlement was very much against Mastercard for much of this year, but all the numbers said to hold.

In Canada, the oil, pipeline, and financial stocks are all performing well. We're also seeing some resurgence in the gold sector, which is also making windfall profits at the current gold price. Gold and base metal stocks are cyclical with the economy. Generally, when the economy is stronger, these companies earn even more and often present trading opportunities as the economy fluctuates. While not as good earnings compounders as the banks, they do make hay while the sun shines and a well managed company like our portfolio holding Agnico Eagle definitely merits a place in our portfolio. We must also mention the effect of interest rates on equity values. As we've said before, the higher the level of interest rates, the lower the growth rate of equity markets. While this is still generally true for growth type stocks, we are seeing more examples of this not being the case for companies that are growing at a rate far greater than inflation, such as a technology sector.

With the 10-year US treasury yield hovering around 4.65% due to the growing US deficit and Iran war concerns, we are pleasantly surprised that the strength of the overall stock market. The fixed-income market has been stuck at these level levels for some time, and we'd only expect prices to improve with an end of the Iran war and an easing of inflationary pressure.

Free cash flow is another important consideration, as it allows companies to grow, buy back shares, or increase dividends. When cash flow decreases or goes negative, as we are beginning to see in the large AI names, it is an early warning sign of overspending and trouble ahead. When companies are going through a big capital spend, returns tend to be more muted until cash flow returns to positive territory. Google and Meta, two of the leading AI developers, have both underperformed this year as result of their AI spending. Last quarter, when the market thought AI spending might slow down, there was a ripple effect on Microsoft and Amazon that sent the shares lower, but with this quarter's results showing that their data storage businesses were continuing to grow at a remarkable pace, their shares quickly rose in value. It is impossible to predict when the AI spending spree will end, but we continue to believe that the need for data storage will continue to grow, even after the battle for AI supremacy has ended.

Good management, growing earnings and cash flow, competitive advantage and a strong customer base are some of the key building blocks of value in a company. There are other considerations for stock selection, such as market sentiment and economic conditions as well. Our goal is to distil all these various factors to bring you the best possible investment options. Until next month, stay well.

As always, questions, concerns, comments and feedback are welcome.

Yours truly,

Walter, Charles, Trevor and the Cooper Wealth Management team

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