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An enriching strategy for quality assets

By FRANCOIS ROCHON, The Gazette January 18, 2011

Before I go about where I'm finding bargains these days, let met introduce myself. I am Francois Rochon. I started investing my own money in the stock market in 1993 and then founded Giverny Capital -a wealth management firm -in 1998.

When I started investing, I wanted to obtain great results with very low risks (who doesn't?). I discovered the philosophy of Warren Buffett and, by using it, had satisfactory results.

Now let's talk about my favourite subject: stocks. As a value investor, I always look for the best place to invest our precious savings. In other words, where can our capital yield superior returns with the lowest risk level possible? At the beginning of 2011, two things strike me as quite obvious. First, the big multinationals in the U.S. are undervalued (with P/E ratios in the low teens). Secondly, the Canadian dollar being probably 20 per cent overvalued gives us an additional discount when acquiring U.S. stocks.

I follow stocks from all over the world. I believe that the bigger the pond you fish in, the greater the chance to catch great fish. These days, the "best fish" are the large U.S. companies, with some trading at low valuations.

Medtronic, for example, is the world's largest medical device maker: It has large competitive advantage and the market it serves is bound to grow for many years. Its stock is unappreciated because of the U.S. health-care reform that will put pressure on margins. But Medtronic has half of its revenues coming from outside the U.S., so it will not be hurt as much as the market fears. It trades at only 10 times earnings. Similar things could be said about other medical products companies such as Johnson & Johnson and Abbot Labs.

Many technology stocks -after being market darlings 10 years ago -also are quite undervalued. For example, Hewlett-Packard, Texas Instruments and Microsoft trade at around 10 times earnings, a ratio unthinkable a few years back. These are worldwide leaders with pristine balance sheets.

This is a once in a generation opportunity to acquire high-quality companies at probably a 50-per-cent discount to their intrinsic value. They also yield on average two to three per cent, which is better than holding bonds -which have almost no capital gains potential.

Simple math suggests that if a stock's earnings per share grow between seven and nine per cent a year and have a yield of two to three per cent, you earn something like nine to 12 per cent by holding it many years.

But if you add a P/E increment of 50 per cent over a five-year period (if it goes from 12 times to 18 times for example), that yearly stock's return climbs to close to 20 per cent a year. Not bad for investing in companies with very low intrinsic risk.

And if you'd like an additional incentive -why not? -you can acquire these undervalued securities with an overvalued currency: the loonie.

During the last 10 years, the Canadian dollar has appreciated 50 per cent compared with its U.S. counterpart. It has climbed from $0.67 to $1.00. Since the Organization for Economic Co-operation and Development (OECD) estimates that the price purchasing parity (PPP) of the Canadian currency is $0.82, it would seem that it is overvalued by around 20 per cent.

During that time -even with commodities doing so well -the PPP has stayed constant. The real GDP growth rate between Canada and the United States has been similar (two per cent annually since 2004). And the GDP per capita in the U.S. is still 24 per cent higher than in Canada ($48,500 vs. $39,000).

Currently, the Canadian stock market trades at almost 158 per cent of GDP (in PPP terms) as compared with around 103 per cent for the U.S. stock market. To me, this is a gap that is bound to be closed in the years to come.

I know it sounds unpatriotic, but there is simply no rational for the Canadian dollar to be at par with the U.S. dollar. I can forget the OECD for a few minutes and just go to the United States to compare prices: Everything on a similar basis is around 20-per cent cheaper.

I try not to be affected by speculation and emotions when analyzing investment securities. I am an agnostic in predicting short-term movements in stock prices and currencies.

I just believe that rational analyses point to a strong value proposition when we look at the prices of U.S. blue-chips. And usually, acquiring quality assets when they are undervalued and unpopular (these are often linked), is an enriching strategy.