We buy more apples when they are cheaper, why not Apple?

cuffelinks.com.au/buy-apples-cheaper-not-apple/

Ashley Owen

The prices of supermarket groceries change from one week to the next, and often from day to day, depending on a host of factors like supply, demand, stock levels, competitor activity, the weather, etc. When prices are low, consumers buy and when prices are high, they avoid products or look for cheaper substitutes.

When a supermarket manager announces an item is suddenly marked down by 20% for today only, there is a rush to buy. What would happen if the manager announced instead that the price of a particular item is *increased* by 20%? Nobody would buy it of course. People know that prices go up and down regularly so they will wait for a better time to buy later.

Investor reactions to shares are the exact opposite

On the price side – aside from a general long term rise for inflation and overall economic growth – share prices go up and down in the short term and much of it has nothing to do with the company itself. Companies report their progress every quarter- or half-year and in between they occasionally announce something, but the share price will jump up and down every day and even every minute.

But investors jump in and buy shares if they have been rising, and the higher the price rise, the more excited buyers become. If a share price is falling, people sell. The lower the price goes the more frenzied the panic selling. It’s the same in every cycle, usually unrelated to the long-term prospects of individual companies.

The difference is knowledge.

When we buy groceries, petrol, cars, etc, we know enough about what we are buying to form a pretty good view of its value and what we are prepared to pay for it. If prices rise above what we see as its real value, we wait.

With company shares, most people have little or no idea what each company is worth and or the fair value of one of its shares. When prices are rising, uninformed investors think: “It must be good because everybody else is buying and the price is going up. I’ll follow the crowd and jump in to get some too!” And vice versa.

This is what is happening in the market

On Friday 2 February 2018, the US market fell by 2% and by another 4% on Monday 5 February. Australia followed suit a day later, as it always does.

Let’s look at one company, **Apple**, the largest listed company in the world worth about 1 trillion Australian dollars, or about the same as the largest 100 ASX companies combined. Last year Apple had sales revenue of US$90 billion and made $20 billion in net profits. It is still growing strongly, with revenues up by 60% last year and net profit 80%. It pays a 1.6% dividend yield but choses to reinvest most of its profits to build its business and to buy back its own shares to reduce the number of shares outstanding so existing shareholders get a larger share of the profits and dividends. The company makes good products that people want to buy and its profit margins are very high. It is currently priced at around 16 times last year’s earnings and about 12 times the expected earnings this year.

It’s a good company and cheap on almost any measure. It is the largest holding in index funds of international shares and it is also held by many active global share funds.

On 18 January 2018, its shares traded at $179 but by 5 February, it had fallen by 12% to $156.

What should we do after such a fall?

The main choices with Apple shares are:

a) Dump it because it has lost 12% in two weeks and is obviously going to go straight down so we’d better get our money out fast.

b) Take advantage of the discount today to buy more. “We were happy to own it at $179 so it would be an even better buy at $156.”

c) Ignore the short-term share price jumps up and down as market ‘noise’ that is unrelated to the company itself. Warren Buffett said: ‘Buy great companies and then ignore the share price.’

d) Step back for a moment and think about whether the underlying causes of the recent price moves might be good or bad for the company, and then take your time to adjust holdings.

Response a) is what you would be tempted to do if you read all the shrill headlines in the media and listen to all those ‘experts’ on the endless financial news channels. The way to lose money is to follow the crowd in ‘buying high’ and ‘selling low’. Novice investors like to see prices rising for a while before they pluck up the courage to follow the crowd and jump in (the ‘fear of missing out’). Then when prices start falling, they panic and follow the crowd in selling out.

The problem is that the markets have been so calm over the past year it has given people a false sense of security, so every minor fall is seen as a major catastrophe.

Response b) involves doing the opposite of the headlines and the crowd. Experienced investors should have done the research, know what they are buying and are waiting for these types of price discounts to buy more.

I have a list of companies I would like to own but they are too expensive most of the time. But every year or so there is a general market sell-off triggered by factors unrelated to individual companies, so I get out the list and see if any are cheap enough to buy. *General sell-offs are buying opportunities. I wish they came around more often.*

Response c) has worked for Warren Buffett for 60 years but it really only works with some control or influence in the investee companies, and that is a major part of his success.

Response d) is best for long-term investors who can look beyond the short-term noise and can make portfolio adjustments when changing market conditions do impact individual companies.

So let's ask what triggered the recent general market sell-off, and then ask how it might affect individual companies like Apple.

There are two themes hitting the market – inflation and the US dollar

First, the general sell-off was triggered by last Friday's report on jobs and wages growth, which showed that the US economy is expanding better than expected, and consumer spending and wages are improving.

That is good news for just about everything – better growth, more jobs, higher wages, increased spending, higher company revenues, profits and dividends. But it also means that interest rate hikes may have to be stepped up a little to counter inflationary pressures. Interest rates were zero from the Lehman bankruptcy in 2008 to December 2015, they are now 1.5% and heading higher to around 5%. The only question is the pace.

Companies like Apple will probably benefit from more jobs, higher wages and increased consumer spending.

The second major theme is the US dollar, which is locked in a currency war between the US, China, Japan and Europe. The US generally has maintained a 'strong dollar' policy, which is good for confidence and makes Americans feel richer but bad for US exporters, which are most of the big US companies. On 24 January 2018 in Davos, the new Treasury Secretary Steve Mnuchin appeared to reveal a departure from the official strong dollar line, and it has raised fears of a dollar sell-off that might trigger a major bond sell-off.

Would a lower dollar would be good or bad for Apple? Since an increasing proportion of Apple's revenues and profits – and most of its growth – comes from foreign sales, a lower US dollar would boost US dollar profits for shareholders.

The other possibility is that this latest jobs report and recent spike in bond yields is just another false start in the long road to recovery for the US economy. Jobs numbers and unemployment filings are notoriously volatile and we are just as likely to see it reverse next month, but the long-term trend is for an improving US economy. That's great news.

The other good news is that we are probably a long way yet from runaway inflation that needs to be countered by rapid interest rate rises by the Fed. Low to moderate inflation and interest rates (under 5%) are generally good for share prices, but high inflation and interest rates (above 5%) are generally bad for share prices.

This is an example of our response d) to the question raised about what to do in response to big changes in prices. If we look beyond the market noise and silly media headlines we start to build a picture of the likely impacts of changing market conditions on the prospects for companies. Each company is affected in different ways by changes in market conditions.

Misleading media headlines

The headlines today are complete beat-ups. The 1,000-point fall in the Dow Jones Industrial Index was 'the largest one day points fall in history!' Yes, but that's only because the index was 25,000 to start with. What's important is the *percentage* fall, not the number of *points*.

For example the largest ever 1-day fall in the Dow was 19 October 1987 when it fell -22.6% but in points terms it was a mere 508 point fall – less than half the points of this weeks 4% fall but much more serious. 'Points' are pointless, percentages count.

In percentage terms there have been plenty of falls in the Dow like the 4% fall on Monday. Since 1980, there have been 37 falls of 4% or worse, the index is up 2800% in total or 9% compound per year.

In Australia, Tuesday's 3% was similarly a dime-a-dozen fall. I have seen more than 50 falls of 3% or more.

In summary, ignore the headlines and the media chatter and focus instead on understanding what the underlying changes might mean for markets, asset classes and individual securities, and stick to a long-term strategy.

Ashley Owen is Chief Investment Officer at advisory firm Stanford Brown and The Lunar Group. He is also a Director of Third Link Investment Managers, a fund that supports Australian charities. This article is general information that does not consider the circumstances of any individual.

webinar: SMSF Retirement Insights – A new framework for thinking about retirement income, 21 Feb . . .

webinar: Navigating the risks in rising rates – 15 Feb . . .

Gemma Dale, Director of SMSF and Investor Behaviour appearing at ASX Investor Day in various cities Feb-Mar 2018 . . .

expands sales presence in Australia appointing Scott Bradley as National Business Development Manager . . .