3 mistakes committed by the stock market

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It seems that very few people understand this fact: a stock has real value. This is called "intrinsic value".

If you are offered a stock that guarantees you a profit of $1 in 10 minutes and nothing afterwards, how much is that stock worth? The answer: $1. It's simple: the intrinsic value of an asset (for example, a stock) is exactly the sum of the discounted profits that asset will produce over time. Nothing more. Nothing less. It's precise. It’s not "air".

This notion should open the eyes of anyone who thinks that the price of a stock is unfounded. A question of supply and demand. A reflection of the economy in general. A piece of paper that you can bet on like in a casino. The reality is rather that if you have a good idea of a company's future profits, you can estimate its intrinsic value. The price of a stock will reflect this intrinsic value sooner or later.

<u>Stock valuations and intrinsic values</u>

For many companies, especially in the tech industry, stock valuations can seem out of touch with their true intrinsic value.

This can be caused by the fact that the markets pay too much attention to revenues, focus only on revenue growth and use overly ambitious future profitability assumptions.

Revenues versus profits

In 2019, Walmart made $524 billion in revenue, and Apple made $260 billion in revenue, which is about half of Walmart's revenue. On these revenues, Walmart obtained a net profit of 15 billion, versus 55 billion for Apple.

Not all revenues are created equal. Some generate much more profit than others.

Revenue growth

Likewise, the growth in a company's revenues does not necessarily correlate with the growth in its profits or intrinsic value. This is a common mistake, especially in times of low interest rates, as this economic environment encourages investors to seek growth.

However, it can be easy to grow revenues, as revenues can be "bought" while real profits cannot be "bought". Let me explain: if I sell, for $0.50, a product or service that is worth $1.00, I will probably sell as many as I want. I will then be able to post exceptional revenue growth. If the cost of money goes down (through low interest rates or high stock valuations), this practice can go on for a long time. In the long run, however, the lack of profits will normally be reflected in the share price.

Exaggerated assumptions

Often, analysts want to participate in the craze for a certain stock because the fear of missing out can be very strong. However, these analysts use rational models to base their decisions. Unfortunately, these models can give irrational results if the wrong assumptions are used.

It can be dangerous to assume that:

- Current revenues are of quality, when the business is continually losing money.
- Future losses are due to the company's choice of temporarily investing more in marketing.
- The company will continue to grow rapidly and one day generate huge profit margins.

Making a profit is difficult. We must not get confused between profits and revenues.

<u>The forces that bring stock prices back to order</u>

When an irrational phenomenon lasts for a few years, people come to think that it is indeed rational.

Companies have expenses and they have 3 ways to cover these expenses:

1. By making profits (quality revenues)
2. By issuing stock
3. By issuing debt (borrowing money)

When money is cheap (like it is today), it's easier for a business to use points 2 and 3 to pay for expenses. McLean Capital's view is that it is much safer and more sustainable for a business to rely on point 1 to cover its expenses.

Sooner or later, a business's ability to issue stock or borrow money should become difficult. If this company is not able to make a profit or is not able to clearly demonstrate that it will ever be able to make a profit, its share price should fall back to earth and reflect its true intrinsic value.

Conversely, a company that generates a lot of profit, but whose stock is not moving, will be able to use its profits to buy back its own shares and therefore, bring the price back to order. It can also use its profits to increase its dividend or make quality acquisitions; all gestures that should also bring the price of the stock back to order.

<u>Conclusion</u>

You have to be careful of the fashions and trends of the day and always try to understand the difference between a speculative security and a quality investment.

The intrinsic value of a security should not reflect the potential for revenue growth, but rather the potential for profit growth. Market forces should ensure that this rule holds true in the long run.

Be prudent with your investments.