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MVAM Newsletter

'Flipping Heck!! Why Stocks Move Around So Much....' March 2016

There is only one Channel Tunnel and for the foreseeable future there will only ever be one. The cost to build another in today's money would be around £13 billion. The tunnel will make its operators, Groupe Eurotunnel, about £120m pre-tax profit this year. That's a return for a potential new tunnel of less than 1%.

Eurotunnel trades on the stock market. So what value does the market place on the company? The £13 billion *replacement cost* of the tunnel, or does it use the £120m *earnings* to base its value. Quite clearly with a market value of £4 billion it is the earnings that are used to base its value. This example underlines how a company should be valued by the market. They should be valued at the *lower* of its earnings or replacement cost.

However, in most cases, it is much harder to work out the replacement cost of a company than it is for Eurotunnel. How much would it cost to replace, or would it be even possible to replace, companies like Coca-Cola or Nestle? Because it is so much harder to value replacement cost the market tends to focus almost entirely on earnings. This focus on earnings when it should be on both earnings and replacement cost is one of the main causes of why stocks move around so much, as every so often, usually when the economic outlook becomes cloudy, the markets remember what they should be doing. Stocks make big moves as they flip from being valued on earnings to being valued at replacement cost or vice-versa.

Hold on a moment, hold on a moment I hear you say. Why do we at MVAM buy companies that currently have no earnings? If the market should be valuing them at the lower of their earnings or their replacement cost they should be valued at zero? Hmmm, good point to some extent. Certainly in times like now sellers appear from nowhere for small companies and buyers are scarce as there are no earnings. Shares fall sharply. However, we own them because as we have said big moves in the market are usually made at the flip point. This can happen for both big and small companies although it is obviously accentuated if a company has no earnings at present.

One more example. We visited a small company last month that has no earnings. We like the stock but it has fallen 25% in recent months despite getting ever closer to selling its products. The market is erring on valuing the company at zero. By looking at the company though we think the ten years of research into new materials has a much higher replacement cost than the market current value of the company. We think that the market will soon flip from valuing the company on earnings to replacement cost once the first products are sold. If that happens, Hey Presto, the stock jumps sharply. That is why we do own some stocks that do not yet make money. At times like this the wait can be painful but as long as the company delivers the flip will come….