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WATCHLIST THE GLOBE AND MAIL

A different perspective on investing in Amazon

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PUBLISHED FEBRUARY 6, 2017

We were inspired to write about Amazon.com Inc. after reading a recent article in The Globe and Mail profiling the stock. The contributor acknowledged that the company generates razor-thin profit margins and that the stock trades at a "ridiculously high" price-to-earnings multiple (192 to be exact). However, the article's conclusion was that despite the high P/E, the stock was worth purchasing as it was likely to be even more pricey a year from now. That advice left us scratching our heads and eager to share a different perspective on Amazon as a potential investment.

While the future is always uncertain, let's be generous and assume that over the next five years, all of the following things transpire at Amazon (we would characterize this as an optimistic scenario):

- Revenue continues to grow at 20 per cent a year;
- Profit margins triple from 1.6 per cent at present to 4.9 per cent;
- The company doesn't issue any more stock options;
- Amazon is able to finance its growth without issuing any additional shares.

If all of that happens, Amazon will earn approximately $32 (U.S.) per share in 2021. At the recent share price of $839, this implies a 26 times price-to-earnings multiple on those future earnings. By comparison, one of the best retailers in the world – Costco Wholesale Corp. – currently trades at a 30 times price-to-earnings multiple. In other words, even if things go very right for Amazon, shareholders may not earn a satisfactory return given the current stock valuation.

Now, what could go wrong? First, the law of large numbers suggest that Amazon will likely struggle to maintain its current 20 per cent revenue growth rate for the next five years. Second, even the best of retailers struggle to earn a 4.9 per cent profit margin. For example, Costco earns about a 2 per cent profit margin. Finally, dilution via stock options is virtually guaranteed. From our perspective, the risk/reward proposition for Amazon is markedly unattractive.

Recommending the stock based on a different view of how the future will unfold for Amazon is perfectly legitimate. For example, rapid expansion of higher margin services

such as Amazon Web Services could cause future profit margins to exceed our 4.9 per cent "optimistic" assumption. Unlikely in our view, but still feasible.

However, recommending the stock because it is likely to be even more pricey a year from now isn't. In fact, this has a name in the investment industry. It's called the greater fool theory. We would posit that this is not investing, it is pure speculation. Amazon may ultimately turn out to be a profitable investment – only time will tell. But for GreensKeeper and our clients, we will take Charlie Munger's advice and simply pass.

"I think part of the popularity of Berkshire Hathaway is that we look like people who have found a trick," Mr. Munger once said. "It's not brilliance. It's just avoiding stupidity." One component of compounding capital is avoiding unforced errors. With a broad investment universe in which to look for value, we prefer putting our money to work when the odds of a favourable outcome are decidedly in our favour.

The Amazon case study also highlights another important investing concept. Despite our distaste for the stock at current prices, we wish to be clear on one point. Amazon is an amazing company. Under chief executive Jeff Bezos's visionary leadership, the company continues to grow rapidly by reinventing retail and online business services. As consumers, we are big fans as our many orders of the past year will attest. It is the valuation with which we take exception.

Successful investors understand it is important to know the difference between a great business and an attractive investment. After all, even the best business is not worth an infinite amount of money. They also know that it is when you are able to purchase a stock at a steep discount to its true worth or intrinsic value that you experience truly superior investment returns while also mitigating risk.

Michael McCloskey is the founder and president of GreensKeeper Asset Management. GreensKeeper and certain accounts managed by it may hold long equity positions of a profiled company and may from time to time trade in these securities.