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Why I'm taking a pass on Apple

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As a consumer, I love Apple Inc. What's not to like? They make fantastic products that are user-friendly and often leading-edge.

At first glance, the stock also appears attractive. The company has pricing power, market-leading margins, a cult-like legion of customers and a fortress-like balance sheet with $145-billion (U.S.) of cash and equivalents. And the shares appear cheap – trading at less than 12 times earnings. A value investor's dream, correct? Perhaps not.

Success as a value investor involves more than just mechanically looking for stocks with low price-to-earnings or price-to-book ratios. It is the qualitative judgments regarding the future performance of the business that are often the most critical.

Many stocks are cheap according to these easily calculated ratios. The real art is to determine whether they are cheap for a valid reason that is likely to persist.

On occasion our firm finds a situation where the market has overreacted to a passing phenomenon. It is only in these situations that stocks are truly mispriced and we try to take advantage by purchasing the stock.

We decided to pass on Apple for a very simple reason – our inability to predict what the company will look like in the coming years. Rapidly changing technology is fantastic for consumers, but not so much for investors. Change is the enemy of business.

In fiscal 2012, Apple's flagship product – the iPhone – accounted for more than 60 per cent of Apple's operating profit. My personal favourite – the iPad – represented another 10 per cent to 15 per cent of Apple's operating profit for the year. In other words, three quarters of Apple's operating profit comes from two products. The iPhone did not exist seven years ago. The iPad only came into existence in 2010.

Apple's talented engineers and other employees notwithstanding, we believe that no one can tell what Apple will look like in five years. We know that we cannot.

Will competition cause fat profit margins to erode or lead to a loss of market share? Will the company go back to earning $6.20 per share as it did only five years ago or will earnings continue to grow from here? We simply don't know with any degree of conviction. The industry simply changes too fast and in ways that we find impossible to predict. As a result, we can't value the stock.

In investing, there is no shame in saying that you don't know and moving on. However, failing to recognize your limitations is likely to bring future pain.

Some would argue that Apple's walled garden or "ecosystem" will keep the company's customers tied to its products and coming back for more. We believe that in time the quality of Apple's moat will reveal itself to be less secure than those who own the stock are assuming.

A hot new smartphone (for example, the Samsung Galaxy S4) may be all that it takes to lure away customers or at least put downward pressure on margins. Or maybe a competitor will invent a product that we haven't even dreamed of yet.

Perhaps we are being too harsh on Apple's future prospects and we acknowledge that the company may continue to be the market leader in premium smartphones, tablets and whatever comes next. Or perhaps Apple's next products could be failures like the Apple Pippin and Newton.

In either case, without a high degree of conviction about how things will evolve from here we choose to invest our money elsewhere.

In a universe of investment opportunities, there is no need to come to a definitive conclusion on the future direction of every stock. We simply choose to look for and invest in opportunities that are easier to predict.