Diary of a Private Investor Apple Colm Fagan 6 December 2015

Apple Corporation, famed for its iPhone, iPad, etc., sharply divides investor opinion. Some think it is grossly undervalued, but the market price sets the equilibrium between buyers and sellers, so the believers must be balanced by an equal weight of investors who think it's overvalued. I have been a believer ever since I took my first bite of Apple in December 2012 at $73 a share. (The actual share price at the time was $510 but a 7 for 1 stock split in June 2014 gave me seven times as many shares at one-seventh the price.) I added to my holding a number of times since then at prices ranging from $72 to $130, compared to the current $117 a share. On average, I am just about breaking even in dollar terms but the stronger dollar ($100 was worth €77 in December 2012, is worth €92 now) puts me ahead in Euro terms.

Apple's results announcement for the year to 30th of September 2015 was an opportunity either to reaffirm my faith or to join the ranks of nonbelievers. The company's profits for the year were $9.22 a share, equivalent to an earnings yield of 7.9% at the current share price. That is a very high yield for what is arguably the leading technology company of our age. It is the type of return we want from a staid company operating in a mature industry; we demand a higher return from such companies to compensate for the risk that earnings may stagnate or even fall in future.

Apple's earnings per share grew by 43% in 2015 and by an average of 34% per annum over the last five years. For companies that consistently achieve growth of this order, investors are normally satisfied with an earnings yield of 5% or less; equivalent to a Price/Earnings (P/E) ratio of 20 or more (P/E ratio is the inverse of earnings yield). Facebook, for instance, has a P/E ratio close to 100. Applying a P/E ratio of 20 to Apple's earnings of $9.22 implies a share price of $184.40, more than 50% above the current price.

Why is Apple's share price so low? The reason is that the market – the unbelieving part of it anyway – apparently thinks that Apple's best years are behind it, that it has limited scope to grow and could even decline in future. It is easy to see where the sceptics are coming from. The iPhone is Apple's most popular product, selling a phenomenal 231 million units in fiscal 2015, up 37% on 2014. It accounts for two thirds of Apple's total revenues. iPhone sales must eventually decline and the market is unsure what will replace it.

In my opinion, Apple is far from a spent force. Sales in greater China are still growing strongly: they grew by 84% in the last fiscal year and the momentum is expected to continue through fiscal 2016. India, another massive market, has been a relative laggard but is now the recipient of a strong marketing effort and sales there are expected to grow significantly. Apple has also demonstrated a great ability to persuade existing customers to upgrade to newer models and, contrary to expectations, is winning customers from Android devices. This success has much to do with the fact that Apple is close to, or has already attained, the status of a luxury brand. Luxury brands have greater longevity, command premium prices - and normally have high P/E ratios.

Apple is investing $8 billion a year in research and development. Some of that goes on upgrades to existing products but Tim Cook, Apple's CEO, has said that the car is the ultimate mobile device, hinting at where some of the R&D money is being spent, and I would not be surprised if Apple moves into the motor market in the not too distant future, either on its own or in partnership with a major motor manufacturer. That could create an entirely new revenue stream.

Apple's dividend is only $2.08 per share, equivalent to a dividend yield of just 1.8% at the current share price. The low dividend yield is not because Apple is short of cash: on the contrary, it has net cash of more than $150 billion, or over $27 a share. Instead of paying a higher dividend, Apple is using its excess cash to buy back shares from investors, thereby reducing the number of shares in issue. In effect, it is making its own shares something of a luxury item. For example, in 2015 Apple's profits grew by 35% but earnings per share (EPS) grew by 43% because the denominator in the EPS calculation, being the number of shares in issue, fell by 5.4% due to share buybacks.

The strong dollar means that sales growth outside the US can translate into zero growth or even sales declines in dollar terms. Arguably, by investing now when the dollar is strong I am also exposed to the risk of the dollar depreciating against the Euro, but a weaker dollar would mean higher sales in dollar terms, which would compensate in large measure for any loss of value from a weaker currency: it's a case of swings and roundabouts.

At the current share price I am more than happy to maintain my high exposure to Apple. I'm hoping that this particular Apple will not fall to earth.