At Current Prices, Tobacco Is No-Go

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Back in December, I recommended that readers **" watch their ash "** when investing in tobacco stocks. In their hunt for yield in a seemingly yield-less world, investors had bid the price of most tobacco stocks to levels that no longer made sense.

Tobacco is a no-growth business and an industry in terminal decline. As a case in point, American teenagers are more likely to use illegal drugs that to light up a cigarette.

In the circular logic of the stock market, the lack of growth is part of what has made tobacco stocks such fantastic investments in recent years. Management doesn't have to reinvest in the business or to fund an expensive marketing budget. And there are no white elephant projects or unrealistic management spin. They understand the economics of their business, and they do the only things that make sense: they pay out gargantuan dividends and aggressively buy back their shares.

But the key here is investor expectations. Investors had low expectations for the sector and were unwilling to pay up for earnings. Ultimately, the success of any investment depends on the price you pay, and tobacco investors were able to enjoy monster returns precisely because the stocks were cheap.

Well, they're not anymore. Not by a long shot. By Wall Street Journal estimates, the forward P/E on the S&P 500 is 13.5. **Philip Morris International (NYSE:$ PM)** is significantly more expensive than that, and **Altria (NYSE:$ MO)** and **Lorillard (NYSE:$ LO)** are essentially at the same valuation.

Company	Ticker	Forward P/E	Dividend Yield	Payout Ratio	1-Yr Div. Gr. Rate
Philip Morris International	PM	15.5	3.90%	63%	10%
Altria	MO	13.5	5.10%	83%	7%
Lorillard	LO	13.4	5.20%	71%	19%
Intel	INTC	9.9	4.20%	41%	7%
Microsoft	MSFT	8.6	3.30%	45%	15%
Cisco Systems	CSCO	10	2.70%	23%	75%

This should not be. ***Tobacco stocks should not be more expensive than the rest of the market.***

Yes, all pay significantly more in dividends than the S&P 500, which pays a pitiful 2.0%. But look at the payout ratios. All pay out the majority of their earnings as dividends, whereas the payout ratio of the S&P 500 is less than 30%.

Meanwhile, take a look at the technology stocks at the bottom of the chart. **Intel (Nasdaq:$ INTC), Microsoft (Nasdaq:$ MSFT)** and **Cisco Systems (Nasdaq:$ CSCO)** all trade for 10 times or less expected earnings, and all have modest dividend payouts with plenty of room for growth. They pay a little less in dividends than tobacco stocksâ€¦but not that much less. And their dividend growth rates are comparable (with the exception of Cisco, whose growth rate is off the charts).

Last month I joked that chipmaker **Intel was my favorite "tobacco stock,"** arguing that Intel had quite a bit in common with the likes of an Altria and its peers:

As the Big Tobacco has proven for decades, companies in declining industries can make excellent investments under the right conditions. If you have a dominant market position (think back to Warren Buffett's "moats"), a conservative balance sheet, and have ample cash flow for share repurchases and dividends, you can do quite well by your investors even in a shrinking market. It's worked for Big Tobacco investors, and it will work for Intel investors as well.

The same could be said for Microsoft and Cisco. **Tech is the new tobacco.**

To be fair, tobacco companies have certain advantages that "tobacco companies" like Intel lack. A chemically-addicted clientele, for starters, as well as an unrivaled ability to raise prices virtually at will. Whenever a progressive-minded (or cash-strapped) city decides to hike the taxes on cigarettes, the taxes flow right through to the customer. Not too many companies have that ability.

But that said, I'm betting that Big Tech is a better investment than Big Tobacco. Investors are expecting no growth from Big Tech. So, if actual results prove to be even marginally better than disastrous, investors should enjoy a decade or more of solid gains.

Microsoft and Intel in particular may or may not ever figure out the mobile market. But that's ok. Given that a zero percent probability is currently priced into shares, mobile success can be thought of as an embedded call option that could end up paying off in a big way. And if that option is never exercised, you're still getting the existing businesses at "tobacco" prices.

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