Why Past Share Price Performance Doesn't Matter

Description

When considering which shares to buy and sell, it is all too easy to focus on their past performance. For example, investors may decide to buy a company which has recorded above average share price performance in recent months. Similarly, they may sell a stock which has been a constant underperformer. However, this could prove to be an illogical strategy when investing for the long term. After all, it goes against the idea of buying low and selling high.

Valuation

Perhaps the biggest problem with deciding whether to buy or sell a share based on past performance is that it limits the future upside or downside. For instance, going back to the example of a company which has risen significantly in recent months, there may be limited profit potential for new investors due to a relatively high valuation. Therefore, it may make more sense to in fact buy a stock which has endured a difficult period, since it may trade on a lower valuation and offer more upside.

Similarly, buying companies which have fallen significantly of late could be a better idea than selling them. The market will have already priced in many of the challenges they face and their valuations may include a wide margin of safety. This can protect investors from further falls as well as offer the scope for significant capital gains.

Emotional difficulties

Furthermore, buying shares based on their past performance means that an investor has nothing to fall back on if things do not pan out as expected. In other words, their reason for buying or selling will have been relatively weak compared to another investor who focused on cash flow, balance sheet strength and management expertise and/or strategy.

This can lead to difficulties for the investor who is focused on past share price performance, since they may end up 'chasing' a company's share price. This means that they may overreact to what prove to be short term challenges rather than significant movements in the share price. In such situations, an investor who has a more detailed and thorough rationale for their investment may find it easier to cope with paper losses. As such, they may be more patient, end up spending less in trading costs and prove to be more profitable in the long run.

When past performance does matter

Of course, the past performance of the stock market can be helpful in specific situations. It shows that the economy and market operate in cycles, and that bear and bull markets are only ever temporary. Beyond that, however, there is little to gain from looking at history since no two companies, bubbles, crises or years are ever the same for the stock market.

Therefore, focusing on company fundamentals and forecasting how a business could perform given its strategy in a range of future scenarios seems to be a far better idea than simply buying or selling shares based on their past performance.

CATEGORY

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