How to Become a Better Investor

Description

Even the very best investors make mistakes and have room for improvement. For example, Warren Buffett has bought numerous stocks over the years which he has gone on to sell at a loss. In fact, it is impossible for any investor to build a perfect portfolio, since there are a large number of known unknowns at any given time. However, by focusing on a company's economic moat versus its peers, it is possible to improve your investment returns.

A company's strength

A company's economic moat is essentially the same as its competitive advantage. In other words, why it is in a better position to deliver growing profitability over the long run than its sector peers. For example, it may have a lower cost base or more customer loyalty than its peers, or could even operate in more favourable geographic areas.

However, measuring a company's economic moat can be challenging. Although costs can be measured, it is difficult to compare them to sector peers unless the company in question operates within a sector where costs are easily comparable, such as in the resources industry. Similarly, measuring customer loyalty is highly subjective, while pinpointing the best economies of the world is fraught with difficulty since they are likely to chop and change over the medium term.

Past performance

Therefore, it pays to consider how a business has performed in the past. Of course, history is never repeated in the future, but it does provide an indication of how a company could perform in differing economic circumstances. For example, it is worth considering how profitability changed during the global financial crisis. That's because there is likely to be a recession of some sort over the coming years, simply because the economic cycle means that growth will not always be positive.

Companies which were able to perform well during that tough period could be viewed as having a wider economic moat than their peers. Similarly, companies which have been able to exploit the more favourable economic conditions of more recent years could be worth buying due to the likelihood that in the long run, the world economy will continue to offer high growth prospects. As such, through analysing past performance, it is possible to gauge how a business will perform in future and how strong its competitive advantage is versus sector peers.

Effects on investment performance

While there is no magic wand to suddenly make any investor better at investing, focusing more keenly on a company's economic moat could yield improved results. Forecasting anything beyond the short runin terms of results is challenging, while concentrating on valuations may lead to a failure to correctly ascertain a company's risk profile. And while income investing has proved popular in recent years, higher inflation and higher interest rates could make it less successful in future years.

As such, a company's economic moat may be the one area which remains of great importance whatever the economic conditions or challenges facing the stock market. Although it is subjective, analysing a company's position versus its rivals in a range of market conditions could make you a better investor who can more easily outperform the wider index.

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