Is Valuing A Stock A Waste Of Time?

Description

Value investing is a popular method used to decide which shares to buy and sell. The idea behind it is quite simple: avoid paying too much for a stock. While value investing has been used by many successful investors such as Warren Buffett, there are many other drivers behind a share price other than its valuation. For example, a company's financial strength, profitability and economic moat. Could they be more important than a company's valuation in determining the level of capital gains?

Limitations

Clearly, every investment strategy has its flaws. Value investing's obvious flaw is that the best companies rarely trade at low valuations. This can be applied on either an absolute or relative basis. In other words, investors seeking companies which have a P/E ratio below a specific threshold may never end up buying the very best companies. That's because they are likely to always trade at a premium due to their strong fundamentals. Similarly, those same companies are rarely cheap compared to sector peers, since they offer either superior return potential or lower risk.

Furthermore, it could be argued that valuing a company means an investor will miss out on significant share price gains. Just as valuing a company can be used to determine whether to buy, it also determines when to sell a specific stock. In other words, if a company's share price appears to be excessive, value investors may decide to sell up and walk away. However, many investors have profited from overvalued shares becoming even more expensive. Therefore, in such scenarios, value investing may be somewhat limited in its ability to generate outstanding profits in the long run.

Catalysts

In addition, it could be argued that few investors will buy a stock simply because it is cheap. There is usually a catalyst required to drive a share price upwards. This could be in the form of growing earnings, an improving balance sheet, growing dividend, a change in strategy or some other event which justifies a higher share price. This means that buying cheap shares may be insufficient to generate index-beating profits, since catalysts may be required in order to push a company's share price higher.

In such scenarios, it is likely for a company's share price to rise no matter what its previous valuation, since it represents a change in outlook or risk profile which the market may seek to reward via a higher valuation. Therefore, whether the stock was cheap or expensive before improved profitability or a higher dividend came along may not have a major impact on its share price.

Takeaway

As with every other investment strategy, value investing has its limitations. It can mean investors miss out on major share price gains, while failing to focus on the key catalysts which could equate to capital gains. However, valuing a company may not be a complete waste of time, since it can lower risk and lead to more consistent returns. Therefore, alongside a focus on a company's potential catalysts, valuing a company seems to be a worthwhile pursuit.

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