



Do Economic Moats Really Impact On Stock Prices?

Description

One aspect of investing which is often overlooked is the subject of economic moats. That is, a company's competitive advantage over rivals which operate within the same industry. Certainly, many investors are aware of what an economic moat is. However, they may choose to focus to a greater extent on valuations, growth prospects and financial strength. While all of these areas are also worthwhile considerations when investing, a company's economic moat could prove to be even more crucial in the performance of its shares in the long run.

Impact on risk

While all companies come with a degree of risk, those with wide economic moats tend to have reduced risk compared to their sector peers. This is because they usually have an advantage of some sort which translates into more consistent and robust profitability during difficult periods where trading conditions are more challenging.

For example, a company operating within the mining sector may have an economic moat in the form of lower costs than its rivals. This could mean that if commodity prices fall so that margins are squeezed, the company in question may be able to deliver stronger cash flow. This can then be used to reinvest in new assets or in existing ones in order to generate higher profitability further down the line.

The effect of this on a company's valuation can be positive. Investors may be willing to place a premium valuation on companies which have greater defensive qualities due to the presence of a wide economic moat.

Impact on return

Similarly, a wider economic moat may also lead to higher profitability in the long run. Clearly, companies with narrow economic moats can generate high profitability, but this may not allow them to maximise their returns to the same extent as a rival with a wider economic moat.

For example, a company which has a high degree of customer loyalty from owning one or more strong

brands may be able to generate higher profitability than a rival selling generic goods. The company with high brand loyalty may be able to charge more for an item which has the same cost to produce as a generic, thereby maximising margins for the company with a wide economic moat.

Over time, this can lead to a number of improvements for the business, such as a greater ability to pay dividends, lower debt levels and scope to expand into new territories with the same business model. This can lead to a higher share price in the long run.

Takeaway

Clearly, there is more to investing than solely seeking companies with wide economic moats. However, they can have strong effects on the risk/reward ratio of a business, and can lead to higher valuations as a result. Therefore, for investors who intend on holding shares through the economic cycle in particular, buying stocks with wide economic moats could be a shrewd move.

CATEGORY

1. Investing

PARTNER-FEEDS

1. Msn
2. Newscred
3. Yahoo CA

Category

1. Investing

Date

2025/08/27

Date Created

2017/08/12

Author

peterstephens

default watermark

default watermark