Are You Making This Obvious Investment Mistake?

Description

One of the most difficult aspects of investing is deciding how much to pay for a stock. Clearly, a lower price is always better than a higher price as it means there is a wider margin of safety and higher potential returns.

However, sometimes it may not be possible to buy a company’s shares at a rock-bottom price. For example, the company in question may be performing well and its valuation may never drop into ‘good value’ territory. In such a scenario, an investor may decide to avoid the stock and miss out on strong investment performance in future. This could prove to be a mistake that is repeated and which has a considerable opportunity cost in the long run.

Focusing on quality

Perhaps the best-known proponent of value investing is Warren Buffett. He has recorded exceptional gains on his portfolio over a long period to become one of the richest people on earth. However, even he has stated that he would rather buy a great company at a fair price, rather than a fair company at a great price. In other words, his main focus seems to be on the quality of company in terms of its financial strength, competitive advantage and future growth prospects, rather than its valuation.

This is a logical stance for investors to take. The stock market tends to reward companies that are able to grow earnings at a rapid rate on a consistent basis with a higher share price. It rarely rewards stocks which offer average earnings growth or relatively downbeat earnings outlooks with a higher valuation. Therefore, it makes sense to focus on the stocks which have the potential to beat their peers when it comes to growth, rather than on the companies which are cheap at a particular time.

Focusing on value

Of course, this does not mean that a company’s value should be ignored. Paying an extortionate price for any stock is rarely a sound move – no matter how strong its future prospects are. However, it may be prudent to take into account a company’s quality, historic valuation and the prices of its sector peers when determining what it could be worth. This may help an investor to justify a higher entry point for a stock, and avoid the mistake of missing out on companies with the most attractive long-term growth stories.

Clearly, paying more for any stock means there is a narrower margin of safety on offer. This could lead to greater losses than if a lower stock price had been demanded by an investor before purchase. However, the reality is that buying companies which have better balance sheets, faster-growing profits and a larger competitive advantage generally means less risk than stocks which are struggling financially and operationally.

As such, following Warren Buffett and seeking the best stocks at fair prices could be a worthwhile endeavour. It may mean investors avoid the mistake of missing out on the best investment opportunities due to an over-reliance on valuations.

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