This Factor Could be Hurting Your Investment Returns

Description

All businesses are in a constant state of change. Customer tastes are constantly moving in different directions, competition evolves over time, while technology improvements mean that some goods and services can become outdated.

All companies must therefore respond to such events through change. However, in some cases companies are constantly in a state of restructuring and reorganisation. This can mean high costs over a sustained period of time, which has a negative impact on profitability in the short run. As a result, avoiding such stocks could be a prudent move for long term investors.

Hidden costs

Whenever a company undergoes a period of restructuring or reorganisation, there are inevitably costs associated with it. For example, a restructuring may mean the merger or separation of business units, with the aim of increasing efficiency in the long run. Similarly, a reorganisation may mean changes to management teams which leads to the better delivery of the company’s strategy over time.

However, both of these events create costs. They may be from redundancies, asset disposals or a range of other costs that cause profitability to fall in the year in which they are effected. As such, a company will produce ‘adjusted’ figures which exclude the costs of reorganising or restructuring in order to paint a picture of how the company may be expected to perform once the changes are completed. Therefore, higher costs and lower profitability on a reported basis may not negatively impact on investor sentiment due to the focus on adjusted numbers.

Recurring issues

The problem, though, is that in some cases a company will seek to restructure or reorganise on a fairly regular basis. For example, this may occur when a new management team is put in place, with a new CEO likely to seek to make changes in order to make their mark on the company in question. If a company changes its CEO every handful of years, then the costs associated with change can add up and eat away at profitability and dividend payments over a multi-year time period.

As such, focusing on companies which are less likely to require a major overhaul on a regular basis could be a shrewd move. Clearly, it is difficult to predict when change will occur, but buying shares in companies which have a strong competitive position relative to their sector peers could be a means of reducing the risk of change. They may need to adapt less than their rivals, and this may mean they offer stronger cash flow and profitability in the long run.

Takeaway

While change is a constant for all companies, the costs of change should be considered when buying a stock. After all, restructuring and reorganisation costs may be adjusted out of financial figures, but they could mean lower dividends and a weaker balance sheet in the long run. Therefore, avoiding businesses which have a track record of constant costs associated with change may be a shrewd move.

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