Why Buying Expensive Stocks Could Be a Shrewd Move

Description

Value investing is a popular investment strategy which has delivered success for a wide range of investors. One notable advocate of the strategy is Warren Buffett. He has been able to generate staggering returns over a long period of time, with him adopting a relatively simple strategy of buying high-quality businesses at fair prices.

Of course, value investing is different than simply buying cheap stocks. In the case of the former, the quality of the company in question is central to consideration of 'value' and means that, in some cases, buying expensive stocks could be a sound move. Likewise, avoiding cheap stocks with little growth potential may be a shrewd move.

The right business

As Warren Buffett famously said 'it is better to buy a good business at a fair price, rather than a fair business at a good price'. In other words, the quality of a company really matters, and in some instances it may be worth paying for. Given the gains made in recent years by a variety of stocks in a number of different industries, finding companies that trade on low valuations and which offer impressive outlooks may prove to be highly challenging.

As such, it may be the case that investors must accept that in order to add high-quality stocks to their portfolios at the present time, they may end up paying a relatively high price for them. While this may leave a narrower margin of safety than some investors would normally feel comfortable with, the plus side is that the growth prospects for a wide range of industries and for the world economy in general are positive. This could mean that above-average earnings growth is ahead, which may mean a higher valuation can be justified.

Buying the best

Of course, the best businesses in a given index or industry are likely to trade at a premium to their peers during a variety of market conditions. This could mean that investors seeking to buy cheaper stocks on a relative basis may struggle to access the stronger companies within a specific segment.

Avoiding the better quality stocks could be a mistake, though, since they may be able to maintain, or even expand, their premium versus peers. For example, in a period where tough market conditions are experienced, they may have a wider economic moat than their peers. This may mean they have a higher chance of survival than their rivals, which could equate to less risk. And in a more buoyant market, they could generate faster-growing profitability which helps to justify their valuation.

Takeaway

In an ideal world, investors would be able to buy high-quality stocks at low prices. However, the reality is that during the vast majority of market conditions, it may not be possible to do so. Given that high-quality companies often trade at premiums to their peers, it can sometimes be worth buying relatively expensive stocks in order to obtain the best risk/reward ratios for the long term.

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