# What Happens if You Overpay for a Low Quality Stock?

We focus on buying shares of high quality businesses when they are trading at undervalued prices in the stock market. We believe that doing this will result in good returns for our clients. Yet, all around us, we see people following other strategies and buying shares of low quality businesses that we consider overvalued. So it is interesting to consider — what returns do they typically achieve?

We have to admit that sometimes they do quite well. The stock market is not a mechanical system where a certain action always leads to the same result. Instead, it is a field of probabilities that is marred by human error and unpredictable events. Therefore, while buying shares of high quality business at undervalued prices is likely to lead to good returns over long periods of time, we cannot say with certainty that the strategy will perform well if applied to a small number of investments or a short period of time.

This probabilistic nature of stock investing is precisely what throws so many investors off track. When someone's uncle buys a speculative company that appreciates 1,000 per cent in a short period of time purely due to sentiment, some investors learn false lessons that can be difficult to unlearn. They may embark on years of speculation that disregards business quality and valuation. One helpful point is to always consider — what will be my average return if I make this type of investment tens or hundreds of times? That question will shift your focus from the immediate circumstances, including the excitement surrounding a particular opportunity, to the wisdom of the overall strategy of making that type of investment.

If a person repeatedly buys shares of low quality overvalued stocks, returns will, on average, be poor. That said, there will probably be a few big winners from situations where a company's quality and growth potential was underestimated, and it performed well despite an ambitious purchase price. There may also be some big winners in situations where an overvalued company is acquired by a competitor for strategic reasons. There will no doubt also be many big losers. For a stock to trade at a high valuation, there is typically excess optimism surrounding its prospects. If the business fails to perform in line with that positive outlook, the losses can be punishing.

Many Canadians do not want to be reminded, but Nortel Networks was that kind of company in the late 1990s. The company was trading at a very rich valuation relative to its earnings, based on the belief that it would continue to grow rapidly. It may be a bit unfair to say it was a low quality business at that time, but it did subsequently fail to meet earnings expectations and ended up going bankrupt several years later.

At the end of a decade, someone who repeatedly buys overvalued stocks will probably produce a track record of some big winners, lots of big losers, and lots of stocks that hover somewhere around the same performance as the overall market. The net effect is likely to be a disappointing overall performance, which could lead to a modified financial plan. Learning to think in terms of probabilities can help avoid this result. Using a better investment method that involves assessing business quality and valuation can also help avoid this result. The best investors are always looking for ways to improve the way they think and the way they behave in order to achieve their financial goals.

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