Financial Planning

INVESTMENTS PORTFOLIO STRATEGIES

Voices 3 ways to spot a high-value company (hint: look for moats)

By Allen T. Bond | October 20, 2022

Will Rogers famously said, "I am not so much concerned with the return on capital as I am with the return of capital."

A critical tenet of investing is that more risk can lead to higher returns. But as the volatility of the S&P 500 increases, nervous investors are turning to different strategies to help manage portfolio risk. With the Fed continuing to raise interest rates, the traditional ratios of cash, fixed income and equities may need to be adjusted for the new environment. So how do we enable returns to client portfolios in the face of high inflation and a slower growth environment? In my experience, investing in high-quality companies trading at a discount to full value helps mitigate risk and reduce portfolio volatility.

With this definition in mind, I focus on three fundamental attributes that sustain that value creation.

Competitive advantage

High-quality companies suitable for long-term ownership have the ability to create and grow measurable business value and enable investors to participate alongside that growth and value creation. What makes a company valuable as an investment is not, contrary to popular belief, the short-term success of its products or services; rather, it is the long-term viability of the competitive "moats," in the form of free cash-flow generation created by a company's strategy and execution, that it digs. These moats enable a company to continue investing in its own growth through a challenging market cycle, putting it in a better position to thrive once the market turns more positive.

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Pricing power

Competitive advantages tend to result in companies with strong pricing power — an imperative in an inflationary environment. After the Kansas City Fed's annual conference in August, Chairman of the Federal Reserve Jerome Powell stated that the nation's central bank must "continue to raise interest rates in an effort to prevent rapid price increases from becoming more permanent." Interest rates were raised again in September, with Powell stating, "We anticipate that ongoing increases in the target range for the federal funds rate will be appropriate; the pace of those increases will continue to depend on the incoming data and the evolving outlook for the economy."

In addressing this ongoing issue, companies are citing pricing power to explain or justify how they are protecting their margins. ("Pricing power" for the purposes of this article is the ability to raise prices without incurring backlash from customers — a critical capability in times like these.) The competitive advantages I describe above tend to result in companies with durable pricing power. High-quality businesses with powerful competitive advantages often have more latitude in pricing their goods and services compared to competitors whose brand or product is not as well established with consumers.

Financial resiliency

High-value companies also demonstrate financial resiliency.

Think about resiliency in terms of business models that are not overly cyclical and which have lots of free cash and not a lot of balance sheet leverage, which tends to get companies in trouble during a downturn. Screen for models that have demonstrated stable and consistent high returns on equity over a long time period, ones which have shown resilience in the past and which, based on close analysis, indicate that they will maintain that resilience in the future.

Implementing these three quality fundamentals when analyzing a company can make a determinate difference when investing in the current market.

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