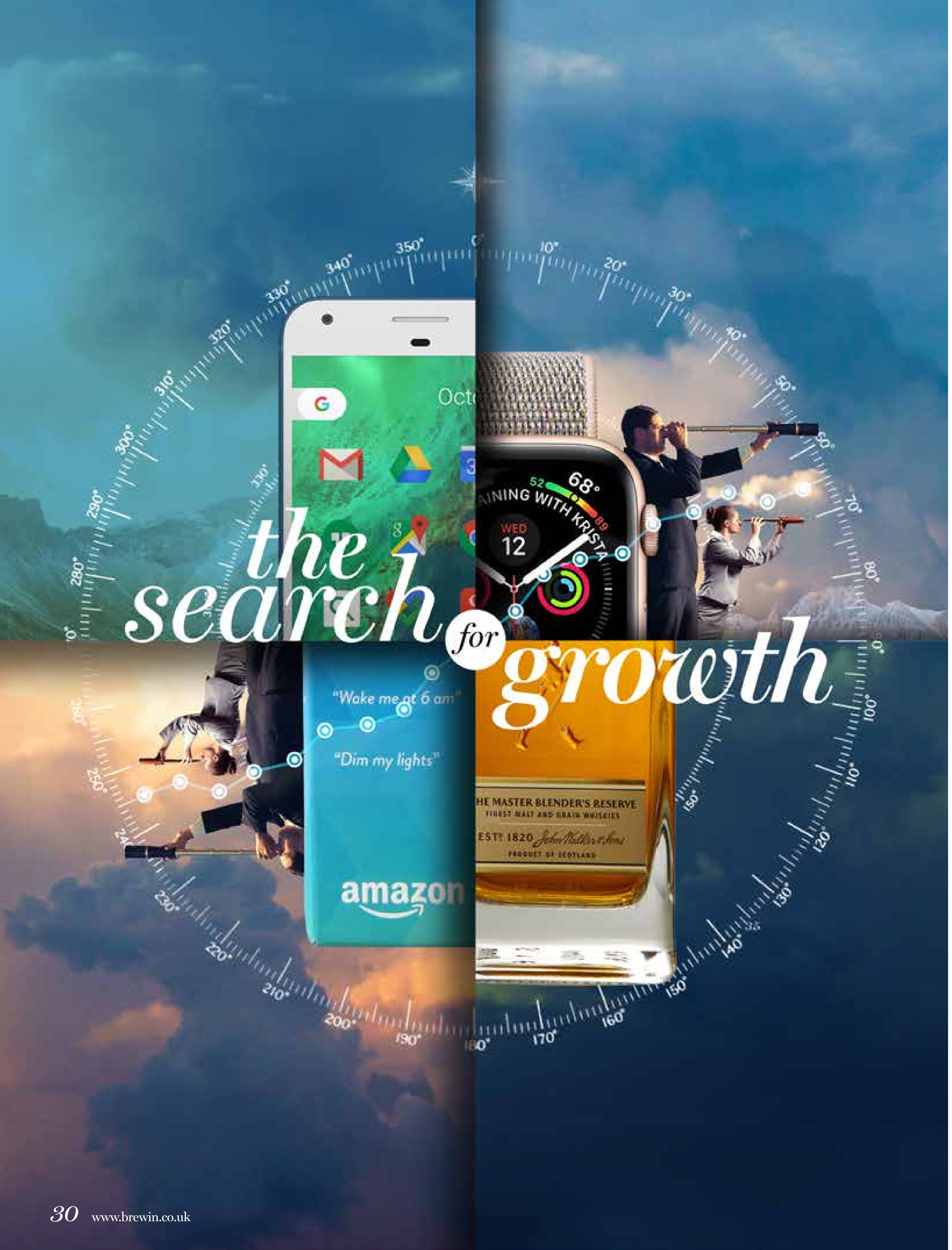
the search for growth



Quantitative easing provided a rising tide that lifted global markets. With the tide now going out, 'stock-picking', based on rigorous analysis, will become even more important to keep portfolios performing. *Paul Bryant* reports

After 10 years of a bull market few investors are complaining, but some argue that the fundamentals of the companies don't match their share price performance; the lingering suggestion is that many companies have inflated values which don't match their prospects. This is a common phenomenon in long bull markets. The strong performance of equities sucks investors into low-cost tracker funds that don't differentiate between stocks based upon their prospects, only their current weighting within the index.

There comes, therefore, a point when the difference between stocks is brought into sharp relief, and it is typically when the market loses the tailwind of supportive monetary policy. As Warren Buffet famously said: "Only when the tide goes out do you discover who's been swimming naked."

So how can you assess potential investments to identify those with the best prospects for growth? To begin with, you need to understand the difference between profitability and growth, and how this affects how companies reward investors – through appreciation in their share price or by distribution of profits through dividend payments.

It's easy to assume that the difference between the best and worst companies is their pace of growth, but the reality is more nuanced. High growth doesn't necessarily mean high profits, and high profits don't necessarily mean rapid growth.

For example, for most products, companies can grow fast by selling them cheaply. In fact, most companies start their life selling goods for less than they cost to produce, and that means losing money.

On the other hand, sales can be very profitable if you charge high enough prices, but growth can be very low, maybe even negative. A company's growth rate is like its accelerator, in that it determines how fast it is travelling, while its profit margin is the equivalent of its gearbox, in that it determines whether it is going forwards or backwards. To continue the metaphor, a company that is growing sales fast but losing money on every sale may be a car crash waiting to happen unless it can make those sales profitable. Investors who can predict which companies will be successful in this endeavour can do extremely well.

Here we examine the characteristics of different stocks from a growth perspective, and the risks and opportunities that they present.

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SECRETS OF THE AMAZON

Amazon shareholders have done incredibly well, but its business profile is quite risky, most often seen in early-stage businesses selling 'new' products or services. Shareholders make their money in these businesses over time through the potential for 'jam tomorrow', profits in years to come, rather than profits now, and by appreciation in the share price driven by investors in anticipation of that profitability. For example, an investment in Amazon shares on the day of the company's IPO in 1997 would have increased in value by more than 800 times by the end of 2018.

Amazon has been marginally profitable for a long time now, but other companies, such as Tesla, which floated on the stock market in 2010, have had a long and arduous path to profitability. For Tesla, this isn't over yet: the company recently had to announce cuts to its prices (this should increase demand, but will make each sale less profitable) while also saving money by closing its stores and moving sales online. (Will the required boost to sales come without those shops?) To still be wrestling with these dilemmas eight years after flotation highlights the challenges high-growth companies face.

Twitter and Snap Inc. have found life harder still, both well down on their IPO prices after five and two years respectively while the wider market has made significant gains.

The typical characteristics of such companies are high valuations (in fact, sometimes traditional valuation metrics cannot be used, reflecting the lack of current profits) and no dividends. While the definition of investing is paying money now in the anticipation of receiving it back in the future, at the earliest stage in a company's life (usually before it graces the stock market) it will likely need successive funding ›

› rounds where investors are asked to plough in more and more money to keep the show on the road. This is also the phase of a company's life when it is most likely to end up worthless, most often because investors can't be persuaded to send good money after bad.

One of the hardest things to appraise about fast-growing companies is whether their growth will attract competition. Even now, growth in the solar industry is at around 30% per annum, but too many companies are vying for this market, causing an index of solar stocks to fall by 70% over the past decade.

A company that is growing fast but losing money may hasten its own demise unless it can invest more money to stay in business. The premise with this type of investing is that the few that are successful will return enough to compensate for the many that go wrong.

> *"A successful approach to investment is one that targets a balance of growth and profits"*

THE SEARCH IS ON...

A more consistently successful approach to investment is one that targets a balance of growth and profits, as offered by companies that are masters of their own destiny rather than slaves to funding whims. They will usually be more established than those pursuing growth at all costs, and because of their higher profitability will typically have lower valuations using traditional measures such as the ratio of profits to share price. Some may have reached the point where they are starting to pay investors back as well as funding their mutual growth. That will be determined by whether their reinvestment opportunities cost more or less than the profits they generate.

Google and Microsoft both have highly profitable core businesses that they use to invest in faster growing businesses as well as giving investors a return. Google does it through buying back shares, Microsoft through paying dividends (and buying shares).

Technology is an obvious place for growth to come, but that growth will often attract competition from other companies. That can be the factor that drives down profits. Being able to consistently earn high profits and grow them is the prerogative of companies with unique products and services. That could be companies whose products are protected by patents (e.g. pharmaceuticals), those with dominant positions in their markets (Google in search, Microsoft in business computing or cloud), companies with very strong brands (consumer goods) and those with subscription business models (software). These factors help build a metaphorical moat around the business that keeps out competitors who might want to share its profits.

GUINNESS IS GOOD FOR YOU

These distinctions are heavily blurred though, and there are a great many sound investments that have rather uninspiring growth, which they have been able to compensate for because they earn such strong profits.

Beverages company Diageo grows at 5%, food producer Unilever is closer to 2%, but both have provided great returns because of their profitable portfolio of brands.

Tobacco is the best example of a sector which in many markets is shrinking, rather than growing. However, smokers are not hugely sensitive to price, which enables companies to continue to earn large profits even as sales decline.

With slowing sales there is relatively little opportunity to reinvest profits, so dividends are high, while valuations are generally low, so there are potential returns to be made – but less opportunity for them to grow.

FROM EXPANSION TO CONTRACTION...

Unfortunately, there will always be too many companies for whom the growth opportunity has dwindled, or the profitability moat has been bridged. For such challenged businesses there are various options that can help, particularly when interest rates are low enough. Borrowing can be used to inflate profits for a while, or to continue paying dividends. But when the business cycle ends, having more debt makes the subsequent pain greater.

That may be a reason why more active fund managers outperform during bear markets than bull markets. ■

THE BREWIN LENS

Head of Research *Guy Foster* explains how Brewin Dolphin seeks out growth potential

Spotting companies that can maintain or grow their market share or profitability takes a great deal of time and effort. It requires experienced eyes poring through accounts and assessing growth opportunities and the likely competition businesses will face in the future.

This is what Brewin Dolphin works extremely hard to achieve. We have invested heavily in an in-house research team consisting of more than 20 staff. They spend their days assessing individual stocks and investment funds to decide whether they could benefit our clients.

Very often the best opportunities are those which we can envisage owning for a long time. During that time the price will undoubtedly fluctuate in ways which are difficult to predict but the trend will be determined by the sustainable profit growth of the company, and analysing that is where we focus much of our effort.

Growth can be driven by a number of factors – demographics, the business cycle or new technology being a few. But growth will be difficult unless we find a company which has a capability or asset that competitors can't replicate. This is variously described as a competitive advantage or metaphorical moat (that keeps other firms from invading their market).

This is why the best investment opportunities are not always the most exciting; after all Einstein is supposed to have described humble compound interest as the eighth wonder of the world. The ability to identify companies which can both generate high returns and reinvest the proceeds at high rates of return is what we seek to find, and what will drive returns for investors going forwards.