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The relevance of growth and dominance in stock selection

By Devanesan Evanson - June 13, 2024 @ 8:05am

The better-than-expected quarterly results has fuelled much enthusiasm in the stock market. Reuters pic

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The FBM KLCI index is expected to be at around 1700 points at year end. Investors will be feeling the adrenaline rush as they evaluate criteria to adopt in their stock selection – and there are many factors to look at. The key criteria will vary amongst different investors.

And the weightage that they will place on their selection basis will also vary.

When investing in stocks, growth potential and market dominance are two critical factors that significantly influence investment decisions. Understanding these aspects can help investors make informed choices, maximize returns, and manage risks effectively.

These factors are important and relevant in the context of stock investments.

Capital Appreciation: Growth potential primarily refers to a company's ability to increase its revenues and profits over time.

Companies with high growth potential are likely to see significant appreciation in their stock prices, offering investors the opportunity for substantial capital gains.

For instance, companies in emerging industries such as technology, biotechnology, and renewable energy often exhibit high growth potential.

Revenue and Earnings Growth: Consistent revenue and earnings growth are strong indicators of a company's health and its ability to expand.

Investors look for companies with robust growth trajectories because such companies are likely to reinvest profits into further expansion, innovation, and development, which can drive long-term profitability and stock price appreciation.

Investors will tend to extrapolate past performance to the future to arrive at valuations.

Even if there are no such past trend of growth, announcements by companies may indicate future potential for growth.

The current rage is those related to AI and data centres.

Investors need to be aware of the join-the-bandwagon syndrome among companies.

Many will announce on AI and data centres, but few will succeed.

Some will announce just to enjoy a share price hike with no serious intention or action plan.

Competitive Advantage: Companies with high growth potential often possess a competitive advantage, such as innovative products, strong brand recognition, or proprietary technology.

These advantages enable them to capture larger market shares, maintain higher profit margins, and fend off competitors, thereby sustaining growth over the long term.

This is the 'moat' that a company has around itself to thwart competitors. The stronger the moat, the better the protection.

Market Trends and Innovations: High growth potential is often aligned with favourable market trends and innovations.

For example, the rapid growth of the internet and smartphones in the late 20th and early 21st centuries created enormous growth opportunities for companies like Amazon, Apple, and Google. Investors who recognized these trends early and invested accordingly saw significant returns.

In Malaysia, a few companies have announced the building of data centres to capitalise on the latest technology trends. A necessary requirement for such AIs is landbanks to build the date centres.

Some property companies may benefit either through the sale of their landbank or developing their landbanks into data centres.

Market Dominance

Market Share and Pricing Power: Market dominance refers to a company's ability to

control a large portion of the market in its industry. Companies with significant market share

often have pricing power, which allows them to set prices higher than competitors without

losing customers. This pricing power leads to higher profit margins and more stable revenue

streams, which are attractive to investors.

Economies of Scale: Dominant market players benefit from economies of scale, where the

per-unit cost of production decreases as the volume of production increases. These cost

advantages enable dominant companies to offer competitive pricing, invest in innovation, and

achieve higher profitability. Investors favour such companies because they are likely to

sustain their competitive edge and profitability over time.

Barriers to Entry: Companies with market dominance typically create high barriers to entry for new competitors.

These barriers can include extensive distribution networks, strong brand loyalty, regulatory advantages, and significant capital requirements.

High barriers to entry protect the dominant company's market position and reduce the risk of market share erosion, making them safer bets for investors.

Strategic Influence and Partnerships: Market-dominant companies often have strategic influence over their industry, allowing them to set industry standards and form beneficial partnerships.

For example, a dominant player in the technology sector may set software standards that others in the industry must follow, reinforcing its market position.

Such influence can lead to sustained competitive advantages and long-term growth. Thus, companies that announce tie-ups with international behemoths like Nvidia and Microsoft will benefit as their strategic partners are internationally renowned.

Resilience During Economic Downturns: Market-dominant companies are generally more resilient during economic downturns. Their strong market positions, robust financials, and loyal customer bases provide a buffer against economic shocks.

For instance, during economic recessions, dominant companies are often better positioned to weather the storm and recover quickly, maintaining their stock value better than less dominant competitors.

Strong consumer companies from the F&B sector jump to mind – we still have to eat.

Integration of Growth Potential and Market Dominance

Synergistic Effects: Companies that exhibit both high growth potential and market dominance provide a compelling investment proposition. The synergy between these factors can lead to exponential growth and stability, creating a balanced investment profile.

For instance, a dominant company in a high-growth industry can leverage its position to capitalize on market trends more effectively than its competitors. These are the ten baggers.

Long-term Value Creation: Investments in companies with both high growth potential and market dominance are often seen as long-term value creators.

These companies are likely to generate sustained revenue and profit growth, reinvest in innovation, and maintain competitive advantages over long periods. Such characteristics make them attractive to long-term investors seeking to build wealth steadily over time.

Diversification and Portfolio Balance: Including stocks with high growth potential and market dominance in a portfolio can enhance diversification and balance. Growth stocks can provide significant returns, while market-dominant stocks offer stability and reduced volatility.

This combination helps in achieving a well-rounded portfolio that can perform well in various market conditions.

Growth potential and market dominance are crucial considerations for investors due to their impact on capital appreciation, competitive advantage, pricing power, economies of scale, and long-term value creation.

By carefully evaluating these factors, investors can make informed decisions that align with their financial goals and risk tolerance, ultimately leading to more successful investment outcomes.

*The writer is a former chief executive officer of Minority Shareholders Watch Group and has over two decades of experience in the Malaysian capital market.