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GROWTH STOCK INVESTING

FIVE COMMON MISSTEPS

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Five Common Missteps in Growth Stock Investing

A well-rounded investment portfolio should include a variety of different investment styles. At Cabot, our investment team spends their time researching equities and fixed income securities to construct well diversified strategies to help our clients reach their goals. Over the course of my investment career, my focus has been on trying to uncover (in many cases) little-known companies on the brink of doing remarkable things. While these companies may offer significant upside potential, investing in growth stocks requires understanding the associated risks and might be worth considering as part of an overall investment strategy.

Investing in growth stocks for more than 40 years has provided me with experience and perspective that few have had. In this piece I will share some insights that may be helpful for those considering investing in growth stocks. There is no sure way of guaranteeing success with any specific strategy. However, proper thought and diligence may help you avoid some costly mistakes.

As we are all aware, the world is constantly changing. Thus, a sensible strategy is identifying those industries and areas of the economy that are changing the most and finding the new leaders in those sectors. This is a great deal easier to write than to execute successfully. Nevertheless, the rewards can be staggering. Companies like Microsoft, Alphabet (Google), Meta (Facebook), Amazon, and Nvidia to name just a few are great examples of long-term winners that have provided long-term returns that have exceeded the returns of the broad market. A word of caution: finding these companies early is not easy, and developing the fortitude to hold on during the entirety of the high growth phase is exceptionally difficult.

Five Common Missteps

I. Missing exceptional growth opportunities because you are afraid or uncertain of some unknowns.

When you see an exceptional growth opportunity, a good approach if you are uncertain (yes – we are all uncertain of the future of these companies) is to simply take the strategy of buying just a little of the stock – maybe 5% or 10% of what you might normally buy. Then watch, study, and learn about the developments of the company. If a positive track develops then buy some more. Then repeat many times. Eventually you will have a meaningful position and will likely become a bit more comfortable with the company.

II. Believing you actually know just how high “high” is and how low “low” is.

In growth stock investing, it is often the “Unforeseeable and Incalculable” that causes us not to know how high “high” really is in a given stock. For example, when I first observed the internet being developed in the late 1980s and early 1990s, few could see companies like Google and Facebook mastering entirely new industries. We had no idea what “Social Media” was at that time and the concept of “searching for information” on the internet was not well understood. Thus, while Google sold at a P/E (price to earnings ratio) of 107 times earnings at the time (when it first went public in 2004), this valuation was five times higher than the average stock on NYSE. Why? The opportunity for growth was simply exceptional.

Early in my career I would agree with the crowd that this P/E was simply too high, and it would not make a good investment. This of course was a very big mistake. Valuation was simply not a good way to determine just how good an investment this company would be. Lesson: We often do not know what we do not know. As a result, being able to determine when a stock is “overvalued” is quite difficult. Therefore, do not assume you will be very good at properly judging the right “value” of an exceptional growth stock.

III. Selling a great growth company with the idea that you will buy it back at the “right” time.

If you have a significant gain in a position and you believe the stock could be vulnerable to a decline, many investors will sell with the idea that they will buy back again at lower prices. This is much easier said than done. A better approach would be to “trim” the position size, thus maintaining ownership in the company.

Determining when to sell a successful holding is one of the most difficult decisions an investor will make. Any sound portfolio strategy should have a loss discipline in place. I suggest you continually check the size of the target market and judge how far along the company is in capturing that market. If it is your judgment that you have tapped only some of the opportunity, then you could hang on for further developments which could mean the company will continue its high growth path.

IV. Being “shaken out” of a good holding due to exceptional stock volatility.

If you are investing in a high growth stock (a company that could grow faster than average), then you should prepare yourself for much higher volatility. It is common for growth stocks to have far higher price volatility than the overall market. In many cases growth companies need to breathe and prices will fluctuate. Large price pullbacks are not uncommon, and you should be prepared for them. A great way to withstand these pullbacks is to take some gains off the table to recoup your initial investment.

V. Holding a company too long and not recognizing that most of the growth is behind the company.

This is not an easy task and there is always an element of uncertainty as you are evaluating. There are three important factors in looking at a company’s growth progress:

Relative Strength: Look at relative strength when compared to a broad-based equity index like the Russell 1000 Index. If the company underperforms on a relative price basis for many years, you must consider that the stock may be maturing, and it is time to move on to a new company with more promising growth prospects.

Penetration Toward the Ultimate Target Market: The farther along, the more likely the growth phase has matured and may not have much runway left.

Competition: Some indicators that a stocks growth is maturing could be slowing sales, declining profitability, and increased competition.

Conclusion

Growth stock investing can lead to incredible investment returns if you have the “right” companies in your portfolio. Harnessing the best entrepreneurs with the power of great innovation and leadership is a very worthwhile goal. Embrace the new, embrace change, and look for the leaders in new parts of our economy. Opportunities are all around us in our complex and innovative world.

It is important to understand the risks associated with investing in any style or asset class. Since growth stocks tend to have more price volatility than the broad investment market, it is critical to assess your risk tolerance, investment timeframe and overall goals to determine how they fit within your overall investment allocation.

About the Author



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Rob is the founder and managing partner of Cabot Wealth Management. He received his MBA degree from the University of Massachusetts in Amherst and his Bachelor of Science degree from Babson College. Rob has taken a strong interest in global research, particularly China and India, and emerging markets in general. Rob has contributed to CNBC and leading publications, such as *Barron's*, *Bloomberg*, and *Reuters*. In addition to his business pursuits, Rob serves an active role in many community organizations, including former Chairman of the Salem State University's Board of Trustees, past Trustee of the National YMCA Retirement Fund, past Chairman of the Salem State Foundation, and past Chair of the North Shore Chamber of Commerce. Rob plays the trumpet in several jazz bands, collects classic cars, and enjoys hiking in the White Mountains of New Hampshire.

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