The rapid pace of innovation and disruption. What does it meant to investors?

By Matt Moberg

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We believe there is no greater force for driving growth and creating value in the economy than innovation. Start-ups, multinational corporations and companies of every size in-between trumpet their innovative products and services. They create centres of innovation and boast of the myriad ways in which they empower employees to think creatively and bring new ideas to the table.

Matt Moberg, vice president, Franklin Equity Group

The pace of disruption is increasing

In the investment landscape, the pace of disruption is increasing. Companies once considered highly attractive can suffer from disintermediation, their products or services rendered obsolete. Many industries are facing challenges.

In transportation, cheaper and faster competitors are rethinking how we move people and goods, while in retail, online competition is driving prices down and curtailing pricing power for traditional brick-and-mortar businesses.

In manufacturing, companies are embracing digital solutions and data analytics and using robotics and artificial intelligence to create significant new efficiencies.

We see a number of structural impediments to strong gross domestic product (GDP) growth in the global economy, including high levels of debt across major economies, adverse demographics in developed markets, a lack of political will for serious structural reform, and rising geopolitical risk, just to name a few.

In this anticipated low and slow-growth environment, we believe investors will place a premium on companies that have “idiosyncratic growth drivers,” and the capacity to grow revenues and earnings - regardless of extant GDP growth - by addressing secular shifts in the way we interact with friends and family, shop and pay for goods and services, treat our illnesses, and spend our leisure time.

The pace of innovation is also increasing

Innovation is pervasive and there have been significant breakthroughs in fields including biotechnology, robotics, artificial intelligence, fifth generation wireless technologies, 3D printing, autonomous vehicles, nanotechnology and more. Our team expects four platforms of growth to generate considerable economic value over the next five to 10 years.

As we look to the future, we believe:

- Robotics could potentially transform the ways in which goods are manufactured.
- Gene sequencing and implantable devices will likely have a deep impact in the healthcare sector.
- Blockchain, virtual currencies and electronic payments should make transactions more secure and convenient.
- Autonomous driving, electric-powered vehicles and the sharing economy are likely to change not only how we move from place to place but how we consume energy and fuel.

In each of these industries, we can apply our time-tested expertise to seek out the innovations that we believe will offer long-duration growth prospects and the greatest investment opportunities.

We seek to invest in sustainable companies at the cutting edge of innovation. But with nearly every company touting its innovation credentials, how do we identify those companies that should truly be able to generate long-lasting growth?

Investing in innovation demands active management

Our ideation process is two-pronged. Thanks to our Silicon Valley location, we benefit from interacting with some of the world’s leading innovators. Our team is constantly reaching out to thought leaders across industries, reading, and meeting with trailblazing companies to understand cutting-edge technologies and ideas that could have transformative potential.

At the same time, our analysts are dedicated to fundamental stock research. Meticulous research helps us develop a deep understanding of the companies we look at.

Our analysts specialise by sector, which allows them to follow one to three related industries and cover approximately 50–70 stocks. They meet management, speak with customers, analyse the competitive environment, and become intimately acquainted with the products or services offered. Analysts also employ a variety of valuation methods to arrive at a target price. They look for companies with superior management, strong financials and sustainable competitive advantages.

In our view, it is difficult to screen for innovation. Historical and comparable valuation multiples may not be helpful. Selecting securities for an innovation-based portfolio requires an unorthodox approach. The team is likely to conduct additional research on companies that are trading above historical multiples rather than below, as the strategy seeks positive inflections, such as acceleration in earnings or price momentum.

In piecing together, the mosaic that leads to an investment decision, we will look at factors suggesting a sustainable growth profile. These might include the pace of user adoption and the total addressable market for an innovative product or service. The combination of intense research with the ability to pursue themes in which we see opportunity is, in our opinion, the optimal strategy for pursuing long-term capital appreciation based on innovation.

We believe that only through active management is it possible to identify and capitalise upon these inflection points. Our experience as an active manager, with years of insight into the impact of innovation, gives us a leg up in identifying the companies that offer the most promising new products, processes and services, and weighting them appropriately in our portfolio given our evolving perception of reward/risk.

Technology stocks aren't purely defined by the Faangs

Our level of conviction regarding the Faangs (Facebook, Apple, Amazon, Netflix and Google/Alphabet) has differed greatly from the overall market over the last decade.

However, that doesn't necessarily mean we have a sceptical view of the Faangss overall. The benefit of active management is our ability to allocate based on our level of conviction regarding the pace of innovation at each company and the sustainability of the growth it creates.

Innovation is everywhere

We believe that innovation is here to stay and should drive growth in the years to come. In the low and slow growth environment that we have experienced since the end of the global financial crisis nearly a decade ago, there has been a premium on companies that benefit from idiosyncratic drivers of growth.

These companies cater to the evolving ways in which we shop, communicate, travel, experience technology and live our lives.

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