

Disruptor Stocks with Exponential Possibilities

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By Tim Morton

Investors are naturally fascinated by the potential for fast growing companies to deliver outsized returns. Some of the difficulties in investing in these companies are their price volatility and trying to profitably time your purchase and sale. It is a challenge to build a long term strategy to invest in these innovative sectors of the economy, however there are solutions to help you accomplish this type of investing through a well thought out plan.

We define "disruptor" stocks, as companies that turn the conventional way of doing business upside down. Many of these disruptor names are front and center in everyday life, think of Amazon, Netflix, Tesla. Other disruptors are less well known, Biogen (biotech based therapies), Match Group (social media dating), Mobileye (autonomous driving).

To identify a portfolio of disruptor stocks we look to various sub sectors for diversification. Diversification can be achieved by holding multiple names and also by considering different ideas or themes.

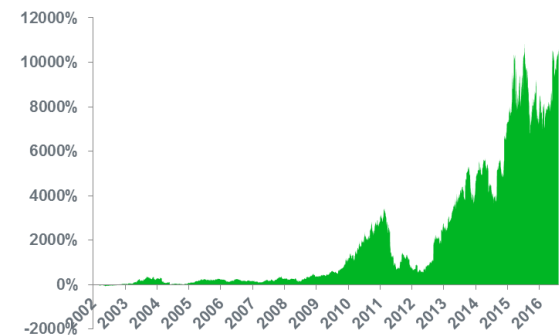
We search for companies that change the way business works. We also want the disruptor companies to have the potential for exponential increases in revenue and earnings. Think global distribution and global profitability.

Sub Sector	Area of Disruption
Energy	new methods of energy generation and storage / transportation
Finance	online payments / fin tech / business communication
Consumer	product distribution / search / social media / entertainment
Medicine	biotechnology that creates new drugs / nano science
Technology	artificial intelligence / software / hardware / 3D printing / robotics

It can be exceptionally difficult to successfully invest in game changing companies as highly volatile price movements can cause investors to deviate from their initial thesis which brought them to the investment. A well-structured strategy seeks to capture as much of the return as possible, while having a plan to contain losses.

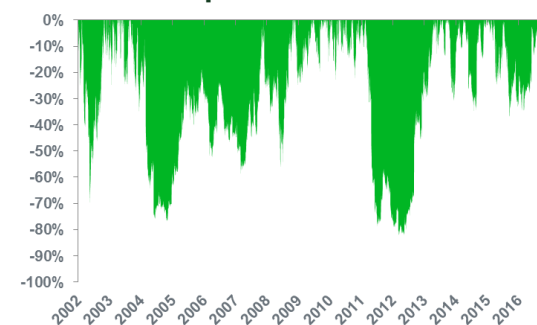
Just look at how difficult it would have been to achieve Netflix's 10,000% return since its 2002 inception. Even the highest conviction investor would have had a difficult time holding a stock though declines of the magnitude exhibited below.

Return



Source: Thompson One, December 31, 2016

Decline from peak



Source: Thompson One, December 31, 2016

One method to manage a volatile portfolio is to design a strategy that is based on mathematics (known in finance as a "quantitative strategy"). Set up a series of rules to govern the portfolio to reduce your emotional involvement. Once investors have identified the most promising and diverse list of companies, there are several methods that could be utilized in a quantitatively based strategy. Possible questions and answers to consider:

Q: What weighting should each company represent in the portfolio?

A: Investors could weight each stock in the portfolio holdings by their historic volatility. While all disruptor stocks are volatile, some are more volatile than others. Investors can track each stock's volatility to calculate the historic loss of value when periodic share price drops occur. Based on this information, one might see that company "A" normally

declines by 20% while company "B" typically declines by 40%. Declines of this magnitude are then to be expected as par for the course, and can be incorporated into building out a plan when they do occur in the future. If you want to attempt to limit a potential loss on both stocks to an equal dollar value (referred to as Risk Parity), you would typically spend half the dollar amount on company "B" versus company "A"

Q: How do I determine when to purchase of the shares?

A: One method we prefer is to purchase stocks when their price is trending upward. You won't be buying at the bottom of a range, but should the trend continue, it will be in your favor. The last thing you want to do is buy a disruptor stock that is failing. Attempting to catch the proverbial falling knife can be hazardous to your financial health if a rebound in price never materializes.

Q: How do I build an investment strategy that allows for taking of profits?

A: Our strategy is to take profits on winning stocks so no single position gets too large. Effectively this is a profit taking mechanism that reduces position size at pre-determined price levels. No single stock will dominate the portfolio and cause a reduction in the diversification that one strives to maintain.

Q: When do I sell the company in the event that its business model has failed temporarily or permanently?

A: We sell when a stock falls below a predetermined price. When a disruptor stock corrects, investors have no way of knowing if this is a normal correction or a more meaningful change in their business outlook. Only well after the fact will you be able to make this determination in perfect hindsight. Having an "uncle" point can aid in protecting capital for a new idea or to re-purchase an existing idea when the trend is in your favor. Remember a -50% decline requires a subsequent 100% gain in order to break even.

You are likely to have many wrong picks before ever finding a big winner, making risk controls very important. Trend following and

having a defined selling strategy allows for potential participation in the upside while potentially limiting the downside. Keep in mind if you invest in an exponential company, it will be a roller coaster ride. Be well diversified and limit your investments to a size that allows you to sleep at night. Enjoy the search for and participation in exponential disruptors.

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