The current economic and market environment is not one in which a rising tide of economic growth will lift all ships; actually, it’s quite the opposite. As businesses compete, the winners will largely succeed at the expense of the losers. Consider recent examples such as Nokia and BlackBerry; both companies once widely recognized as dominating their respective markets, only to be disrupted by innovative competitors.

Disruptive innovation has a variety of implications for the economy, and in turn, financial markets. It has transformed the way in which we interact. Facebook, for example, has connected users from across the globe while also providing a platform that allows people to communicate in an entirely new way. Our media consumption habits have shifted considerably. One can point to Apple’s initial introduction of the iPod back in 2001, which forever altered the landscape of portable media players. More importantly, disruptive innovation has modified our way of conducting business. Look no further than the advent of online retailers such as Amazon, and their impact on traditional brick-and-mortar storefronts. At the same time, disruptions can provide growth opportunities to investors who have the foresight to identify them.

Investors must understand the nuances of disruptive innovation in order to capitalize on its investment opportunities. At a broad level, three distinct forms of disruptive innovation impact our world today:

- High-quality innovation
- Low-end disruptive innovation
- New market creation

High-quality innovation entails a company introducing a new product or service, which in many ways, is superior to existing options in an already-large market that is no longer experiencing much growth, if any. In this instance, should the innovation prove successful, it could garner large market share gains and potentially spur a new leg of industry growth. Conversely, low-end disruptive innovation is when a company introduces a disruptive product or service to a large existing market that is already over-served in terms of satisfying demand. Here, there is room for “good-enough” products or services to come in at a lower price point and take market share from competitors. The third form of disruptive innovation refers to the creation of entirely new markets through the introduction of products or services meant to address unmet demand.

One of the keys to generating absolute and relative returns in today’s slow growth environment is the
ability to identify individual businesses with growth drivers that are not necessarily tied to the broader economy. Disruptive innovators can fit this concept. Investors today may be well-served to seek out companies that can innovate and disrupt their competitors, either by creating new markets, expanding on existing markets, or simply taking share from their rivals, as these types of businesses can offer an attractive risk-return tradeoff.

Despite some of the excitement surrounding investment themes, entirely new industries, and a changing global landscape, it is imperative that investors remain disciplined. While the disruptive innovation concept can help guide market watchers toward potential investment opportunities, valuations certainly matter. This is especially true today as U.S. equity markets generally appear to be fairly valued, or perhaps even slightly expensive, depending on the metric. In fact, the weak performance of certain very high-growth stocks in the U.S. earlier this year represents a prime example of what often happens when too much emphasis is placed on the “story,” with little regard for valuations.

Pursuing these types of stocks can be risky, especially when the technology or innovation is very new and has not been widely adopted. Using a systematic investment framework that thoughtfully explores the market opportunity a company’s disruptive innovations might capture is critical. This process should be rooted in company fundamentals and contain disciplined pricing criteria, so as to avoid investing when valuations are unreasonable. When it comes to evaluating disruptive innovators, in addition to equities in general, flexibility and discernment are critical in order to avoid chasing stocks into speculative territory.

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