3-Step Process to Buy Stocks for Growth

Description

Ever wonder how to buy stocks that are destined to grow? Growth stocks have had an incredible decade. Some technology and retail stocks have quickly expanded and delivered multifold gains for savvy investors who hopped in early. I have no doubt that there are plenty of similar opportunities for investors today.

Here is a simple three-step process to identify and buy stocks that are likely to grow.

Growth indicators

You can categorize companies based on what they do with their cash flows. In other words, what the management decides to do with the profits generated is a clear indicator of the type of stock they represent.

A value stock, for example, may retain most of its earnings. An income or dividend stock pays most of its earnings out to shareholders. However, a growth stock reinvests all its earnings back into the business. This reinvestment could be used to buy more equipment, hire more people, or acquire smaller companies.

Effectively, a growth stock has sales or earnings that increase every year. It also tends to pay a low dividend, if at all. Once you've spotted a growth stock, you need to measure the growth potential.

Constellation Software (TSX:CSU) is a good example. The stock pays a paltry 0.38% dividend. That's because the management team uses nearly all its earnings to acquire small tech companies and expand the business.

Mind the gap

The next step is to figure out how much room a stock has to grow. This step will help you avoid over-hyped industries. Marijuana stocks, for example, were worth many times more than the entire global market size for legal cannabis in 2018. Unsurprisingly, the bubble popped, and investors lost billions.

To avoid this, focus on companies that are still small in relatively massive markets that are still expanding. Constellation Software, for example, is currently worth $29 billion. However, the global market for enterprise software is expected to be worth US$575 billion (CA$765 billion) by 2024. That means there's plenty of room for Constellation to grow.

Buy stocks at fair value

Finally, take a look at some basic valuation ratios to make sure you're getting a fair price. Buy stocks that are at or below fair value. Constellation is trading at a price-to-free cash flow ratio of 22.89. That seems fair considering most tech stocks aren't even cash flow positive yet.

The company also trades at a forward price-to-earnings ratio of 33.2, which is on par with larger enterprise tech competitors. If you buy the stock at fair value, your chances of losing money over time are mitigated. Paying a reasonable price for a growth stock is absolutely critical.

Bottom line

People who decided to buy stocks based on growth potential have had an incredible run over the past decade. Nearly every technology and financial company has delivered multi-fold returns for savvy investors. If you're looking to add more of these growth gems to your portfolio, focus on their relative size, valuation, and growth trends.

The best growth stocks are the ones that can sustain rapid expansion for several years, if not decades.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:CSU (Constellation Software Inc.)

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Category

1. Investing

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