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to inform your decision-making.



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## U.S. Equities **ALPHA GENERATORS IN U.S. LARGE-CAP GROWTH**

### KEY POINTS

- While about a quarter of the Russell 1000 Growth Index's total returns during the past five years have come from FAANG stocks, there are significant opportunities for generating alpha away from the dominant tech and consumer discretionary names.
- Security selection informed by skilled analysis, including field research, can aid a portfolio's prospects for long-term outperformance.
- Apart from using stock-specific insights, alpha can be generated by understanding sector dynamics and weighting subsectors within a sector appropriately to take advantage of these insights.
- We regard our ability to regularly revisit an investment thesis as crucial when analyzing the impact of new technology.

The group of large technology and consumer discretionary companies known as the FAANG stocks have dominated headlines in the large-cap growth equity market in recent years. And, even though they have faced increased volatility in the second half of 2018, this attention has been largely well deserved as the stocks of Facebook, Amazon.com, Apple, Netflix, and Google-parent Alphabet produced outsized long-term returns.

However, about three-quarters of the Russell 1000 Growth Index's total returns during the past five years have come from non-FAANG stocks, and we believe there are significant opportunities for generating alpha away from the tech titans. Fundamental research can help investors identify companies that can add diversification to their portfolio along with the potential for outperformance. In this Price Point, we highlight some examples from across

a variety of sectors—namely payment providers, health care, software as a service (SaaS), and cloud computing—where possessing deep knowledge of a company or subsector yielded attractive investment ideas.

### UNDERSTANDING HOW A COMPANY MAKES MONEY

We believe that a key to being a successful investor is achieving a deep understanding of how companies make money, and our decision to invest in PayPal came from insights into the financial incentives that were driving the actions of several players in the electronic payments industry.

Visa and credit card-issuing banks such as JPMorgan Chase saw upstart PayPal as a threat, but after we spent a significant amount of time analyzing the businesses of Visa, JPMorgan, and PayPal, we saw there was room for these companies to work together profitably. PayPal originally only allowed its customers to make

payments from a bank account, but we realized the company—along with Visa and JPMorgan—could benefit if it allowed customers to link their payments to a credit card. This gave us confidence that PayPal had a growth opportunity in front of it.

After PayPal started to offer the credit card option, new customer sign-ups accelerated. Although earnings took a slight hit initially from the higher expenses of processing credit card transactions, the growing customer base drove PayPal's price/earnings multiple higher than we expected.

### RESPONDING TO CHANGES WITHIN A SECTOR

Apart from using stock-specific insights, a powerful way to drive alpha is understanding what is occurring in a sector and weighting subsectors within a sector appropriately to take advantage of these insights. This theme has informed our approach to health care.

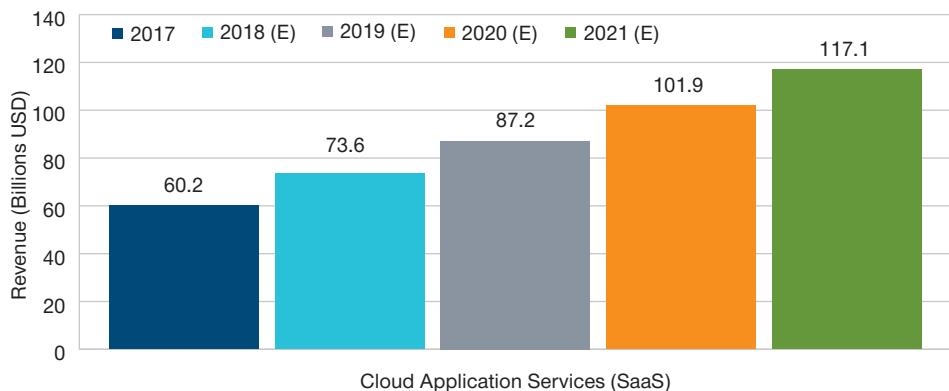
It wasn't long ago that biotechnology companies experienced a golden era as advances in genetics contributed to successes in the development of new treatment options. However, biotechs started to face headwinds in 2015 as their product pipelines shrank and pricing and regulatory pressures increased. At the same time, we saw positive developments occurring in the equipment and supplies and provider segments. We shifted from an overweight to an underweight in biotech as we expanded our allocation to more promising health care subsectors. Over the three years ended in June 2018, equipment and supplies was the strongest segment within the Russell 1000 Growth Index's health care sector, with a 96% gain, while biotech was the weakest segment, declining 19%.

### GAINING INSIGHTS AS A COMPANY GROWS

Our investment in ServiceNow is an example of how being able to follow a

**FIGURE 1: Software as a Service Market Growth**

As of April 30, 2018



Source: Gartner.

company as it develops can generate alpha. Our firm's mid-cap franchise had owned ServiceNow for more than three years before the company grew big enough for it to be considered for our large-cap portfolio.

The insights we received during this period made us comfortable adding it to our portfolio as we saw the benefits of the software as a service business model (see Figure 1). Charging clients annually for services is a less volatile business than selling software products one at a time, which was the old way of operating. But the real benefit is that these companies were able to innovate at a much more rapid rate than their traditional competitors, who often had one big product rollout but then struggled. With the software as a service business model, ServiceNow has continued to succeed in its second and third acts.

### REFINING AN INVESTMENT THESIS WITH NEW RESEARCH

A final example of how we generate alpha involves cloud computing and shows the importance of revisiting an investment thesis when necessary. In 2015, our internal research suggested that businesses would quickly make a complete transition to the cloud and away from maintaining their own tech

infrastructure. And, in fact, we did see a significant migration over the next couple of years. But, as we started to talk to enterprise IT managers about how they were using the cloud and visited their firms to deepen our understanding, we realized the story was a little more nuanced.

The IT managers told us that, even though they were building their new work processes to benefit from the public cloud, they didn't see a financial benefit to transitioning all of their legacy workloads. This shift in tone prompted us to take a fresh look at companies, including Red Hat and VMware, which the market had left for dead based on projections that Amazon was going to completely own the space. Our analysis led us to conclude that they had a vibrant future, and we purchased both Red Hat and VMware for our portfolio. At the same time, our research led us to continue to overweight Amazon. Even though its market share in this area was going to be smaller than anticipated, the total market was larger than we expected, which benefited Amazon.

Our insights into what was going on in the cloud came from our ability to do customer surveys, to attend conferences, and to talk to many consultants and experts in the field. This story exemplifies the point that alpha generation comes from having the resources to do thorough research.

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