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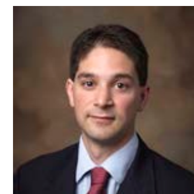
IDENTIFYING ALPHA GENERATORS IN US LARGE-CAP GROWTH



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The group of large US technology and consumer discretionary companies known as the FAANG stocks have dominated headlines in recent years. And even though they have faced increased volatility in the second half of 2018, investor attention has been largely well-deserved, as the stocks of Facebook, Amazon.com, Apple, Netflix, and Google-parent Alphabet have 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. Here are four ways how:

1. UNDERSTANDING HOW A COMPANY MAKES MONEY

We believe the first step to successful investing is developing a deep understanding of how companies make money.

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 analysing 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 realised the company—along with Visa and JP Morgan—could benefit if it allowed customers to link their payments to a credit card.

Once we were confident PayPal had this growth opportunity ahead, we increased our allocation to the company's stock. After PayPal started to offer the credit card option, new customers sign-ups accelerated and the growing customer base drove PayPal's price/earnings multiple higher than we expected.

2. RESPONDING TO CHANGES WITHIN A SECTOR

Apart from 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. We took this approach in healthcare.

It wasn't too 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 around 2015, as their product pipelines shrank and pricing and regulatory pressures increased.

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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 healthcare sector, with a 96% gain, while biotech was the weakest segment, declining 19%.

3. GAINING INSIGHTS AS A COMPANY GROWS

Our investment in ServiceNow is an example of how following a 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. 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 with its second and third acts.

4. REFINING AN INVESTMENT THESIS WITH NEW RESEARCH

A final example of how we generate alpha 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. While we did see a significant migration over the next couple of years, as we started to talk to enterprise IT managers about how they were using the cloud, we realized the story was a little more nuanced.

The IT managers were telling 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 a lot of the consultants and experts in the field. Which brings us to our key finding: regardless of its source, alpha generation almost always comes from thorough research.

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