Growth Matters Even More Amid Uncertainty

Where we look for growth and how much we pay for it are also key.

July 2023

KEY INSIGHTS

- High interest rates and economic uncertainty suggest that valuations should matter more and call for casting a wider net in the hunt for growth.
- Companies that can post robust or even resilient growth may stand out if earnings upside proves to be somewhat scarce this year.
- An unsettled environment can create long-term opportunities for growth managers with the acumen and resources to identify them.

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Stocks have treated investors to a bit of déjà vu this year. The first five months of 2023 recalled the growth-dominated market of 2017 to 2021, as a small number of stocks—Apple, Microsoft, NVIDIA, Amazon.com, and Tesla—contributed about 70% of the Russell 1000 Growth Index's total return.[1]

But the market may have gotten a bit ahead of itself. Gone is the supportive backdrop of near-zero interest rates, benign levels of inflation, and the economic rebound that followed the end of pandemic-related shutdowns. Turmoil in the banking industry has also complicated the outlook.

This uncertainty, in our view, requires a more holistic approach to growth investing that explores opportunities outside familiar grounds and places more of an emphasis on valuation.

Our core focus, however, has not wavered. The strategy still targets the rare companies that we think can deliver an extended run of double-digit rate earnings or cash flow growth—an emphasis that, we believe, could benefit clients in the current environment and beyond.

Heightened Economic Uncertainty...

The fallout from the high-profile failures of some formerly fast-growing regional banks, in our view, has widened the range of macroeconomic outcomes.

Not only can the resulting fear prompt consumers and businesses to become more cautious in their spending, but banks are also likely to rein in lending as they seek to shore up their balance sheets. Both responses would restrict economic activity. These effects, along with the lagging impact of the

“...the market may have gotten a bit ahead of itself.

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> Companies that can post resilient or robust growth are likely to stand out against an uncertain backdrop….

Federal Reserve tightening monetary policy, contribute to a macroeconomic backdrop that appears highly fluid.

On the one hand, if consumer spending proves resilient and the labor market remains tight, the U.S. economy could suffer only a mild downturn or even hold steady. In that case, the Fed may keep rates elevated in a bid to curb inflation. But if the pressures on the banking industry worsen or other cogs in the economy break, a significant contraction in business activity could prompt the central bank to cut interest rates. All these scenarios are plausible.

All eyes will be on key indicators related to inflation, the labor market, and credit conditions. Until greater clarity emerges on the most likely path of travel, alternating worries about inflation and economic growth could translate into choppy markets where sentiment fluctuates between risk-on and risk-off modes.

…Warrants a More Holistic Approach to Growth Investing on Two Fronts

1. The breadth of possible economic scenarios, in our view, argues for casting a wider net to position for a variety of market conditions.

Information technology, consumer discretionary, and other traditional growth sectors are still areas of focus. We are also finding select opportunities for clients in financials, industrials, health care, and other sectors. However, we are not willing to compromise on the quality or the potential durability of these companies' growth stories.

2. High interest rates and economic risks suggest that valuations should matter more than they have in recent years.

Inflation and the rapid increase in borrowing costs erode near-term purchasing power and, for this reason, typically weigh on what investors are willing to pay for the prospect of future earnings. We are keeping a tighter leash on valuations. That means managing position sizes opportunistically on big moves to the upside or downside, especially if these fluctuations in share price do not appear to reflect a change in a company's business outlook.

Earnings Growth Could Matter More as Market Refocuses on Fundamentals

Much of last year's weakness in growth stocks stemmed from valuations coming under pressure as the market reacted to the Fed raising interest rates at the fastest pace in more than four decades.

The U.S. central bank's target interest rate is likely nearer to the peak level for this cycle of monetary tightening, suggesting that earnings and free cash flow could reemerge as important drivers of a stock's relative performance.

Growth stocks generally include higher-quality businesses that may not exhibit as much sensitivity to broader economic conditions as their value counterparts. Still, selectivity is critical. Companies that can post resilient or robust growth are likely to stand out against an uncertain backdrop where consensus expectations suggest that earnings upside could be somewhat scarce this year (Fig. 1).

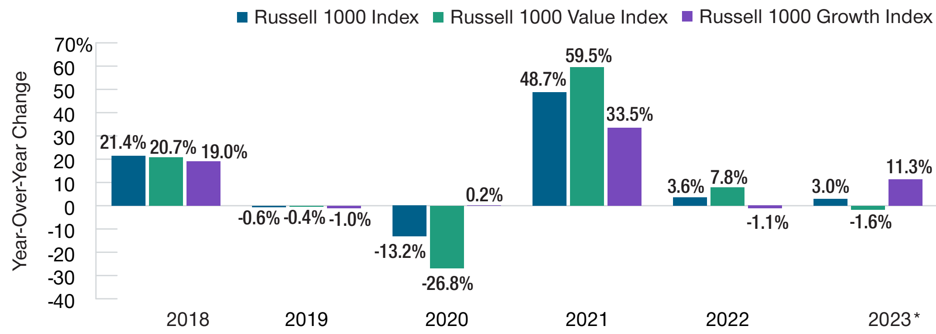
The qualities that we prize in our search for sustained growth—from favorable competitive positioning and margin profiles to capable management teams and exposure to what we view as compelling demand trends—also hold appeal when the outlook for the market and economy is unclear.

1. Focusing on powerful growth stories that we think are still in their early chapters and have the potential to outpace cyclical weakness is one way that we seek to add value for clients.

Robust spending to build capabilities in artificial intelligence (AI), for example, should provide a tailwind to the parts of the semiconductor industry involved in making the advanced chips

Earnings Outlook for Large-Cap Growth Stocks Stands Out

(Fig. 1) Annual growth in earnings per share



As of May 31, 2023.

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Actual outcomes may differ materially from estimates.

*FactSet estimate for calendar year 2023.

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that underpin these technologies. Separating the hype from the actual opportunity is key. Over the long haul, the best-positioned companies stand to benefit from demand growth related to the digitalization of the economy and the rising cost of incremental production as digital semiconductors become more complex.

2. The prospect of steady, if not necessarily heady, earnings growth at a reasonable price can also be compelling.

Telecommunications companies provide essential connectivity to businesses and consumers, which, for scale players, historically resulted in defensive cash flow profiles that were less sensitive to economic conditions. One name in the industry strikes us as well positioned to meet our growth criteria, in part by buying back stock. Competitive dynamics bear watching, but we think the quality of T-Mobile US's wireless network and below-peer pricing could help it to take market share.

3. Out-of-phase growth stories that we believe can play out regardless of the economic environment are another area of emphasis.

Pharmaceuticals is one area of potential opportunity, especially companies with what we regard as strong development pipelines and potential blockbuster drugs that could drive growth over multiple years.

Distinguishing the Short Term From the Long Term to Add Value

The volatility that accompanies macroeconomic uncertainty can create opportunities for active managers. At these times, markets become even more focused on the short term. Investors are also prone to mistaking temporary headwinds, such as slowdowns stemming from pandemic-related dislocations or the business cycle, as secular challenges that could last for longer.

Case Study No. 1: Getting Ahead in the Cloud

Take the ongoing transition to cloud-based infrastructure and services that has been occurring across industries. Demand has wavered in recent quarters as companies that spent heavily on the cloud during the pandemic have paused projects. We view this cyclical weakness as a passing phenomenon that does not diminish the size of the long-term opportunity.

In time, the boom in spending on the hardware necessary to support advanced AI should translate into increased demand for cloud services. This tailwind should become more pronounced, in our view, as AI models transition from the development phase to commercial deployment, at which point they would process inputs and generate outputs for a larger user base.

Case Study No. 2: Potential Growth Opportunities in Financials

Broad-based selling in financial stocks because of recent turmoil in the banking industry has also created opportunities where the market's failure to differentiate has punished some companies that we think have solid growth potential.

Leading property and casualty insurers, for example, take minimal credit risk in their business models and should enjoy an uptick in investment income from higher bond yields. More important, we believe certain companies are well positioned to benefit from a favorable pricing environment for annual premium determinations.

Leaning Into Our Edge

Investors are contending with a much different environment than the relatively benign conditions that prevailed in the decade-plus after the global financial crisis. High interest rates and uncertainty regarding the economy's trajectory call for some modest tactical tweaks.

Above all, however, we remain focused on the underlying fundamentals that typically drive stocks over the long run. We continue to rely on our rigorous internal research to identify the rare companies that we think should be able to grow stronger for longer.

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Reading the Road Signs

Meeting with management teams in person and on their turf can provide useful subtext that does not necessarily come through on a video call.

We have stepped up our travel as we search for insights and opportunities. Being on the ground helps us to build an understanding of a company's culture, operational prowess, and other intangibles that we believe can be important to potentially durable growth. Reading a management team's body language is more art than science, but it adds to our holistic assessment of a company and its prospects. Equally important, traveling with our analysts and fellow portfolio managers provides plenty of opportunity to talk through potential ideas—an invaluable feedback loop.

The stocks mentioned above represented the following allocations in the Growth Stock Fund as of March, 31, 2023: Apple 9.99%, Microsoft 13.14%, Nvidia 4.29%, Amazon.com 5.11%, Tesla 1.21%, and T-Mobile US 0.44%. Listed holdings are presented for illustrative purposes only and do not represent all of the Fund's holdings or future investments. Holdings are as of the date noted, may change at any time and are not recommendations to buy or sell any security. No assumptions should be made that investments in the securities identified and discussed were or will be profitable.

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ID0005855 (07/2023)
202306-2964055