Finding Durability in U.S. Growth Stocks

For investors still concerned with equity volatility, focusing on durable franchises may provide an incentive to stay invested in growth stocks.

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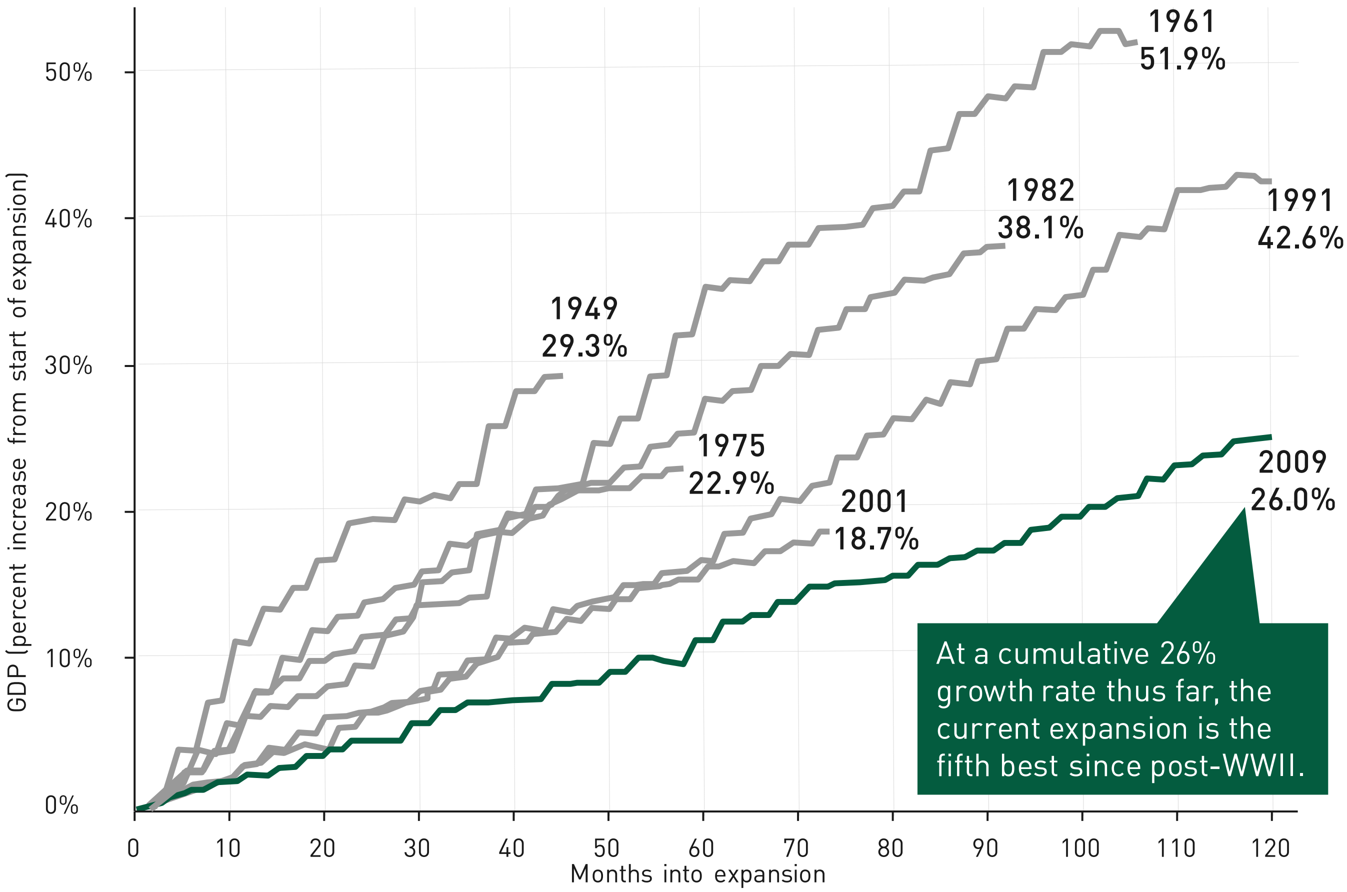
Chart 1. Even Though the Current U.S. Economic Expansion is the Longest, It Has Not Been the Strongest in the Post-War Era

Cumulative U.S. GDP (% increase from start of expansions)



Source: St. Louis Federal Reserve.

In Brief

- The U.S. economy continues to demonstrate resilience, and key data points may suggest we are not as late cycle as the pundits and financial media repeatedly suggest.
- With a persistent backdrop of low inflation, low rates, and low (but positive) GDP growth, U.S. growth stocks continue to outperform the broader equity market—for fundamentally sound reasons, we believe.
- Nevertheless, getting investors to embrace growth stocks and stay invested has been a challenge given recession fears and constant expectations for mean-reversion away from growth.
- A growth-equity strategy focused primarily on company "durability," valuation, and stock-specific factors may help identify firms with quality businesses, resilient earnings, and potentially attractive downside protection.

Growth

Since 2009, we have seen a constant narrative that the United States is just around the corner from the next disaster, and yet it has not come. Remember the coming "double dip recession" fears of 2012? The dire forecasts of how quantitative easing, zero-interest rate policies, and negative interest rates were going to cause hyperinflation? The China growth scare of 2015? Brexit? 2016 elections? Trade wars? Impeachment? End-of-cyclicitis?

Still Expecting a U.S. Recession? Still Expecting Growth Stocks to Lose?

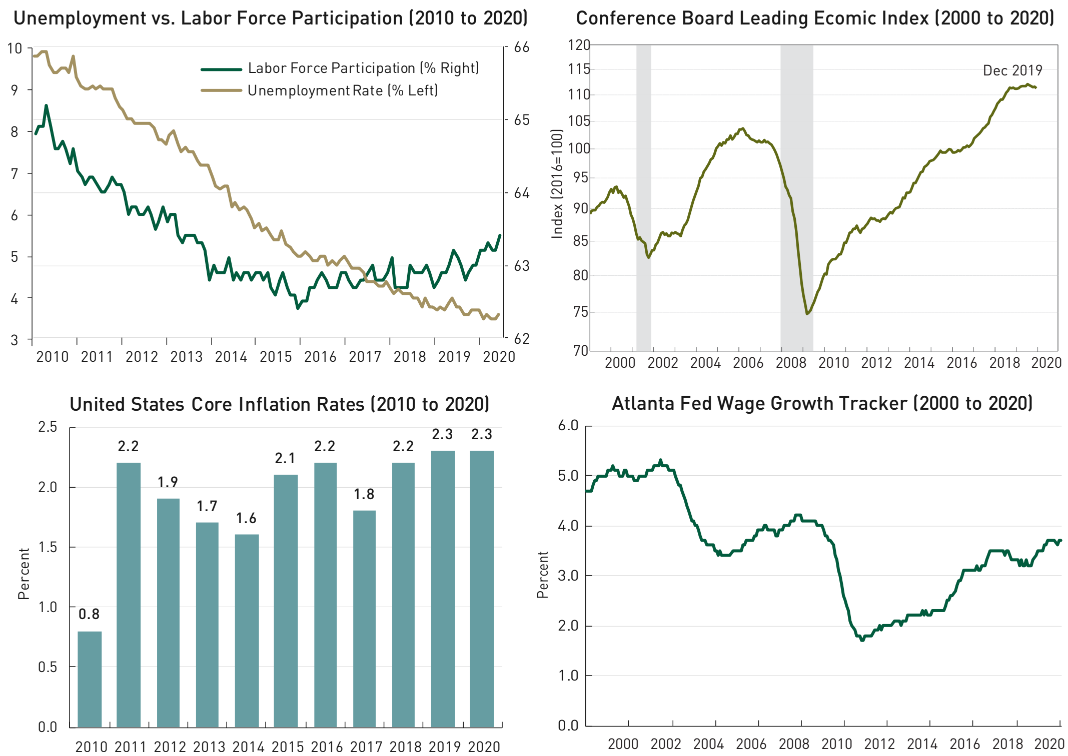
What we have seen amid these pervasive fears are two unmistakable realities: (1) a compelling revenue and earnings story in corporate America, fueled by the broadening technology revolution, a healthy consumer, and enormous policy accommodation, and, potentially (2) excessive risk aversion among mutual fund and pension plan investors, demonstrated by the nearly $3 trillion in outflows from active equities and $1.4 trillion alone just from growth portfolios (including active and passive).[1]

Interestingly, what has been happening in the U.S. economy and the U.S. equity market has not been reflected in investor behavior. Rather than owning the asset classes most dominant over the past nine years—large-cap and mid-cap growth stocks—the average pension plan as well as the average mutual fund investor has instead fled to areas of perceived safety, e.g., bond proxies like utilities, real estate investment trusts, telecoms, some consumer staples, and some areas of fixed income. There has also been a large swath of equity investors over the past decade who've been saying we're overdue for a rally in value stocks so we'd better sell growth altogether—a strategy that doesn't seem to have worked out that well, in our opinion.

The green line in Chart 1 shows the growth of total gross domestic product (GDP) during the current economic expansion, which began in June 2009 (about 26% as of February 21, 2020). That makes the current expansion the fifth best since the end of World War II. First place goes to an eight-year expansion that began in 1961, which had cumulative quarterly GDP growth of almost 52%, suggesting that if we were to reach the same level of prior expansions, we may still have years to go before we see the long-awaited "end to the cycle." (Of course, there can be no guarantee of that happening.)

Stocks

Chart 2. U.S. Employment, Leading Indicators, Inflation, and Wages Suggest a Favorable Economic Backdrop



Sources: Bureau of Labor Statistics (Unemployment vs. Labor Force Participation); The Conference Board (Conference Board Leading Economic Index); U.S Federal Reserve (U.S. Core Inflation and Atlanta Fed Wage Growth). The **labor participation** rate measures the percentage of Americans who are in the labor force, while the **unemployment** rate measures the percentage within the labor force that is currently without a job.

Looking at more specific economic data, we can see four charts above that argue there is perhaps more reason for optimism. We clearly have seen a resilient labor market, strong economic indicators, decent wage growth, and dormant inflation. All of these data points suggest that while the U.S. economy still struggles to grow an average of 2% per annum, a recession may still be far off. (Again, no guarantee.)

This low rate, low inflation, low (but positive) GDP environment has been favorable historically for U.S. growth stocks, primarily because this backdrop generally enables companies to invest for future business expansion and research and development, and is also less dependent on rising economic growth (i.e., cyclicality) for growing revenues and earnings.

And so with little certainty as to what investment styles will outperform in the near term, but with an eye toward owning growth for the long run, a compelling solution can be a growth strategy focused on durable franchises with strong long-term growth prospects, trading at attractive valuations.

Seeking Durability in Growth Companies

Portfolio managers are known to say they seek to own stocks of "quality" companies, almost regardless of the asset class or investment style they employ. Quality is defined subjectively as perhaps a blue chip company, or a highly defensive company, perhaps an innovative high-tech company, or a dividend payer/grower. The thinking goes that if a portfolio manager likes a stock and owns it, then it invariably must be thought of as quality in some way – after all, it's difficult to find managers who seek to own mediocre companies!

Then, there is the more academic definition of quality, the "factor," which strictly defines financial characteristics of companies deemed to have the combination of sound business models and lower downside risk from an investment perspective. The "quality factor" is defined by a number of rigid metrics, including high return on invested capital, low cyclicality, low leverage, and positive earnings. Such metrics are notable in that they may help investors to identify financially sound companies, even though potentially they may limit the ability to identify strong growth companies.

An approach defined instead as "durable growth," which seeks to identify the characteristics outlined on the right-hand side of Table 1, embraces the broad concept of quality, but expands the universe to investing in companies that have strong competitive moats and scalable businesses, but may also not yet be profitable or may in fact have some degree of cyclicality.

Table 1. Distinguishing Between Rigid "Quality" Definitions and "Durable Franchises"

TRADITIONAL CHARACTERISTICS OF "QUALITY"	CHARACTERISTICS OF "DURABLE FRANCHISES"
▪ High Return on Invested Capital	▪ Strong Brand Names
▪ Low Financial Leverage	▪ Dominant Market Share
▪ Positive Earnings	▪ High Barriers to Entry
▪ Stable, Non-Cyclical Growth	▪ Scale Advantages
	▪ Recurring Revenues
	▪ Strong Free Cash Flow
	▪ Patent Protection/Intellectual Property
	▪ Pricing Power
	▪ Experienced Management

Source: Lord Abbett.

Finding a Durable Franchise

What we believe is far more important in such an approach is identifying what we define as a "durable franchise." For example, in our opinion, companies that have demonstrated strong pricing power with a diverse client base (rather than having just a few huge clients that limit their pricing and business agility) tend to have more consistent earnings; companies with strong patent protections and high barriers to entry may have more sustainable advantages; and companies with strong brands, experienced management, and dominant market share might tend to weather more difficult economic environments better than those without those traits.

Seeking Upside Participation and Downside Protection

When considering investors' decade-long flight out of equities, we believe a durability-focused approach to U.S. growth stocks has the distinct benefit of keeping equity allocations in place even during periods of volatility. In our opinion, strategies that focus on the factors mentioned herein—while also concentrating the active risks they take to stock selection rather than to large factor or macro tilts—may demonstrate less downside capture during market drawdowns while still participating in up equity markets. In fact, the one environment that such an approach might lag would be a frothy, excess risk tolerance market where the absolute returns would still be healthy. Clearly, a well-executed approach and repeatable process is essential to delivering such an experience, but we would argue that using a durable approach as a starting point may be a key factor for success.

[1]Source: Simfunds, eVestment, Lord Abbett Research.

IMPORTANT INFORMATION

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Glossary of Terms

Upside capture/downside capture ratio: Upside capture ratios for funds are calculated by taking a fund's monthly return during months when the benchmark had a positive return and dividing it by the benchmark return during that same month. Downside capture ratios are calculated by taking a fund's monthly return during the periods of negative benchmark performance and dividing it by the benchmark return.

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