Investing in Innovation with Growth Stocks

Lord Abbett experts discuss why they believe investors should focus on "revolutionary" advances in technology, healthcare, and consumer experiences—and how to identify the most promising companies in those sectors.

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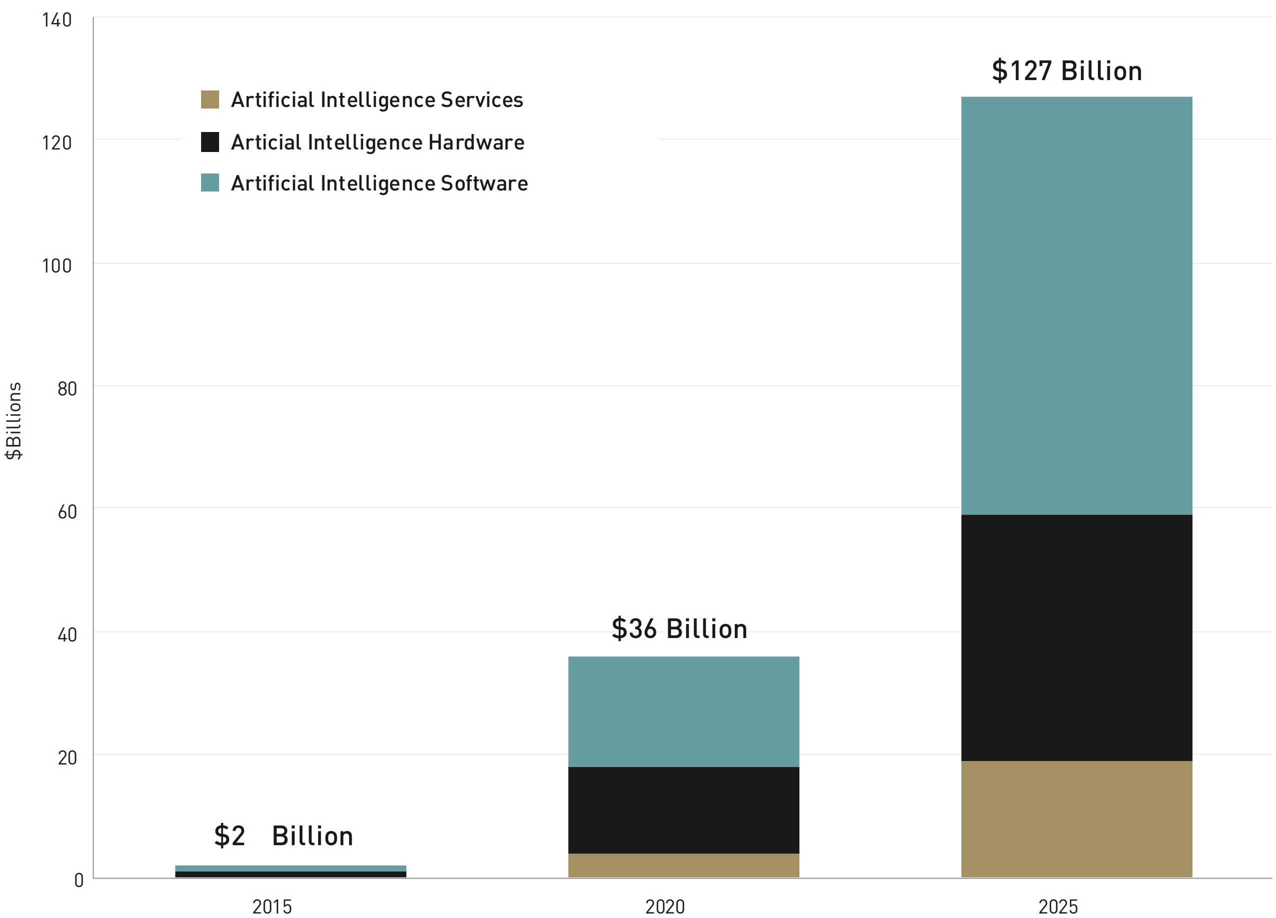
Chart 1. Spending on Artificial Intelligence Points to the Explosive Growth in Technology

Artificial intelligence revenue by segment (US$; estimated for 2020 and 2025)



Source: BofA Merrill Lynch Research estimates.

In Brief

- Mutual fund-flow data[1] suggest that investors have shied away from stocks of innovative, high-growth companies in recent years, and have missed out on significant gains as a result.
- We suggest a focus on stocks that carry an *innovation premium* (discussed below), which we believe offer the potential to add alpha to investment portfolios.
- But it's not enough for these stocks to have growth potential. They should represent companies that have superior records of execution, with solid management.
- Further, given the volatility inherent in such equities, managers should apply price discipline using momentum, a key factor of technical analysis.

Lord Abbett Partner Thomas O'Halloran, J.D., CFA, head of the firm's Innovation Growth Equity team, will be featured in a November 12 webinar entitled "Insights on Innovation Investing." (We encourage you to register for the webinar by clicking here.) In this Market View *co-authored by Investment Strategist Brian Foerster, CFA, the Lord Abbett experts offer a preview of some of the key points they will be covering in their presentation.*

What Is the Innovation Premium?

Many of us are familiar with the concept of the *value premium* and the related concept of investing in stocks with a margin of safety.[2] The idea is that owning stocks trading at meaningful discounts to their theoretical intrinsic value will systematically lead to higher returns than the overall equity market. However, we believe this is an incomplete story about how to invest, as technological innovation can provide an opportunity for long-term investors, even if the stocks of innovators may appear more expensive in the near term.

The relationship between innovation and the value premium suggests that investors may do well to own both for diversification and the potential for more balanced returns over time. Consider the reason value companies demand a premium return: the risk to their current assets and income stream from better-positioned competitors and new market entrants. In our view, it is this displacement risk from competitive innovation that causes the uncertainty reflected in the discounted multiples of value companies. This existential threat from innovation can create an opportunity for astute value managers to identify which companies will survive the innovation threat and earn excess returns.

The flip side of that concept is the risk of underestimating the impact of innovation companies. The common bias among investors is to look at a higher P/E (price-to-earnings) or P/B (price-to-book value) stock and say it's simply overpriced; those focused on absolute current valuations may, in many instances, miss the potential undervaluation of that company's extraordinary growth and market share gains over the longer term. High innovation companies often take market share at a spectacular rate if new technologies are rapidly replacing existing ones (Apple and Amazon are two examples that readily come to mind from the past 20 years).

We believe this rate of change is often meaningfully underestimated in the equity markets. One critical reason why is that the intellectual capital and embedded research and development (R&D) at these innovative companies can be big catalysts for long-term growth that are underestimated or even ignored in their valuations. We call this potential additional compensation for risk in these companies that has the potential to arise from technological change the *innovation premium*. In some ways the phenomenon is systematic in that investors have proven over decades that they persistently underappreciate the future revenue potential derived from R&D investment and the speed of market share gains that innovation incites. In some ways the potential of innovation is best recognized through fundamental research that integrates a complete picture of competitive dynamics. Few observers predicted, after all, the speed with which Amazon displaced Borders, Netflix displaced Blockbuster, and Instagram drove the final stake through Kodak. In our view, investors would do well to seek out both the value premium and the innovation premium as we believe they are related to one another and can drive differentiated sources of alpha in their portfolios.

Why Might Investors Avoid Innovation Growth Stocks?

Our research finds that investors have displayed excessive risk aversion toward innovation growth stocks due to near-term volatility despite the massive potential returns from them over the longer term. We think the experience of the last two decades—with regard to investor flows into equity mutual funds and the performance of key U.S. stock-market benchmarks—bears this out.

Table 1.
What Did Investors in U.S. Mutual Funds Miss When They Soured on Equities in 2009?
Data for 2000-2019 (through September 30)

Years	U.S. Active Equity Fund Flows ($mm)	All Growth Funds Net Flows ($mm)	Performance	
			S&P 500	NASDAQ
2000 - 2008	$395,599	$237,251	- 28.13%	- 61.25%
2009 - 2019	($1,194,159)	($440,664)	302.34%	407.88%

Source: Simfunds, Factset. Data as of September 30, 2019. Data drawn from statistical reports for specific categories within the U.S.-registered mutual funds contained in the Simfund database.

For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

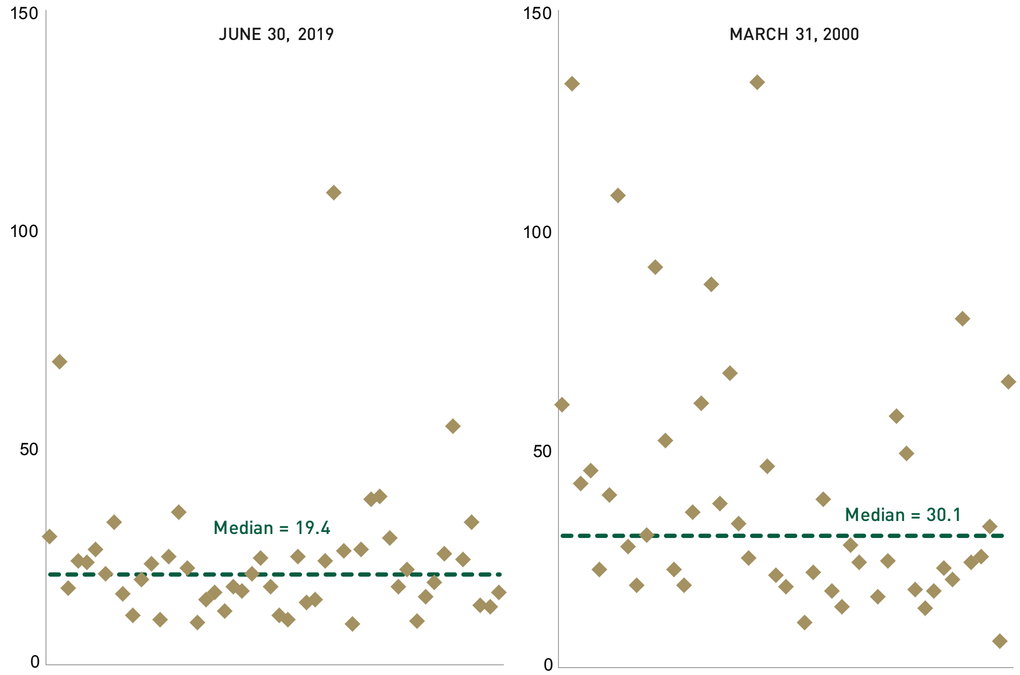
You can see two very different behaviors in the years preceding 2008, and the decade after, in Table 1. The 2000–08 period was a very rough one for U.S. equity markets, especially for the high-growth equities displayed in the third column of Table 1. But based on the flows into both active stock funds and the broader equity universe, investors' risk appetite seemed healthy until 2007–08, which in hindsight, was probably the worst time for them to go into hiding. That's borne out by the remarkable returns for the S&P 500 and Nasdaq Composite Indexes in the bottom line of the table. All the while, equity mutual fund flows from 2009 to the present have been massively negative.

We have observed a number of reasons expressed by pundits and investors alike for the pessimistic tone toward equities today. Chief among them: the decade-long bull market is getting old, and tired, and is due for a big pullback; valuations have become stretched, especially among technology shares (i.e. "it's looking like 1999-2000 all over again"). On that final point, we would simply direct readers to Chart 2 (next page).

What Are the Key Drivers of the Innovation Revolution?

Amid the risk aversion noted earlier, there is tremendous creative destruction and innovation shaping the U.S. and global economies, which we believe creates the opportunity for many companies to achieve very attractive growth rates. We think this is a compelling reason to have exposure to these innovative, and often disruptive, companies. This innovation is manifesting itself in three major segments of the economy:

Chart 2.
Is the Market Headed for a Repeat of 1999–2000? U.S. Equity Valuations Would Suggest Not
Forward P/E ratios of the 50 largest companies in the S&P 500® Index for the indicated dates



Source: Strategas Research Partners – Investment Strategy. Data as of June 30, 2019 (latest available from source).

Past performance is not a reliable indicator or guarantee of future results. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

The Technological Revolution: Advances in computing power, storage, and network speed and reliability have led to tremendous new opportunities such as cloud computing, 5G networks, and artificial intelligence (AI). These revolutionary technologies have created new businesses with strong growth rates. For example, we are closely watching the advent of AI, which we consider the next big growth frontier for technology. AI is a relatively new technology that is being used to support and enhance business processes, and in some instances, supplement human physical and mental activities. As Chart 1 (front page) shows, spending on AI is expected to grow at a 29% annual rate between 2020 and 2025, representing a potentially huge opportunity, both for companies seeking to use AI to develop cutting-edge products and services, and the investors looking to benefit from its future growth.

Healthcare and the Genomics Revolution: We have seen major advances in the understanding of disease, especially cancer, enabled by genomics research. The far lower cost of sequencing genomes has also aided in the development of new biotech drugs that are achieving much greater results. Additionally, newly developed medical devices are enabling the delivery of certain kinds of healthcare in a much less invasive manner. Technology-aided improvements in medical diagnostics are another large opportunity, in our view.

U.S. Mass Consumerism: The U S consumer sector, which represents 70% of gross domestic product (GDP), has been a key beneficiary of the rapid development of technology. The growing market presence of firms in industries such as e-commerce, online dating, social networks, food delivery, and music and video streaming, are clear illustrations of the opportunities created by using technology to make the consumer experience much better.

How Do You Identify the Most Attractive Innovation Stocks?

We have developed a process consisting of three elements. First, we're trying to find the best businesses among the many firms seeking to disrupt their markets. We think that investors persistently underestimate the rate and duration of the potential future growth of these firms, a myopic view that creates a compelling opportunity for astute active managers.

Second, we want to make sure that these disruptors are executing well, that they are demonstrating operating momentum. There are many businesses that we believe waste the potential of their innovative ideas and technologies because of poor execution. It's incumbent on the innovation-focused investment manager to meet with these companies to develop a greater understanding of their capabilities at the operational and managerial levels.

Finally, it all comes down to picking stocks that are going to outperform the market. That's why we carefully monitor movements and underlying trends in their stock prices. We pay attention to the absolute price performance as well as the relative price performance of these stocks. This is done by using a technical analysis discipline known as momentum investing aimed at maximizing the upside from these high-growth companies while also seeking to limit the potential downside that can reflect their inherent volatility. (Read our colleague Vernon Bice's guide to applying the momentum discipline to investing in high-growth stocks.)

Summing Up

We believe that it is important for investors to have at least some part of their asset allocation dedicated to innovation and the technology revolution that is driving the U.S. economy and equity markets. Amid this tide of rapid change, we believe that two long-established equity disciplines—a focus on company and sector fundamentals, and a rigorous application of technical analysis to mitigate the volatility that can accompany high-growth stocks—will continue to serve certain growth strategies well in the years ahead.

Hear more of our "Insights on Innovation Investing" by registering for our webinar. Join it live on November 12, or by accessing a replay in the following days.

[1]In this article, all instances of "mutual funds" refer to U.S.-registered mutual funds.

[2]When the market price of a security is significantly below an investor's estimation of its intrinsic value, the difference is the **margin of safety**. Benjamin Graham and David Dodd coined the term in their 1934 book, *Security Analysis*.

A Note about Risk: The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that markets will perform in a similar manner under similar conditions in the future. All investments involve risks, including the loss of principal invested.

Glossary of Terms

Price-to-Book Value Ratio: Book value is defined as the net asset value of a company, and is calculated by adding up total assets and subtracting liabilities. Book value per share is arrived at by dividing book value by the number of stock shares outstanding. The Price-to-Book Value Ratio (P/BV or P/B) is calculated by dividing the price of a share of stock by the book value per share.

Forward Price-to-Earnings Ratio: Stock analysts calculate a forward price-to-earnings (P/E) ratio by dividing a stock's current price by estimated future earnings per share. Some forward P/Es are calculated based on estimated earnings for the next four quarters, while others use actual earnings from the past two quarters with estimated earnings for the next two. A forward P/E may help you evaluate the current price of a stock in relation to what you can reasonably expect to happen in the near future. In contrast, a trailing P/E is based exclusively on past performance.

The **S&P 500® Index** is widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

The **NASDAQ Composite Index** measures all NASDAQ domestic and non-U.S. based common stocks listed on The NASDAQ Stock Market. The index is market value weighted, meaning that each company's security affects the index in proportion to its market value.

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