Paving a Long Runway for U.S. Growth Equities

Improved valuations and market breadth are key influences

+ Significantly higher interest rates punished U.S. growth equities in 2022, leading to their worst performance relative to value equities in two decades.
+ Improved valuations down market cap, market breadth, and opportunities for stock selection offer an attractive entry point for strategic allocations to growth equities.

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Introduction

Last year brought a decisive end to the quantitative easing (QE) cycle that underwrote global capital markets since the depths of the Global Financial Crisis some 14 year ago. The "about face" resulted from a culmination of pressures that followed the onset of the pandemic—global lockdowns, unprecedented fiscal and monetary stimulus, and the war in Ukraine conspired to bring the highest inflation print in over 40 years, forcing central banks to hike interest rates at the fastest pace in decades. While 2022 triggered a punishing reset for U.S. growth equities, the outlook is decidedly brighter going forward.

In this paper, we discuss how the unwind of distortions built up over the past 14 years is bringing a welcome return of price discovery to equity markets. Following the reset in growth stock valuations, which are now most attractive in small and mid caps, and ongoing improvements in market breadth, we believe active allocations to U.S. growth equities offer investors a long runway for capital appreciation.

The buildup: QE supported market concentration and passive investing

Across equity markets, years of zero-interest-rate policy and easy money fueled multiple expansion and price momentum in the largest stocks, resulting in high name concentration across growth equities. Over the past 5 years ending December 2022, 54% of Russell 1000 Growth Index returns were attributed to contributions from the top 10 stocks by market capitalization (44% came from the top 5 stocks alone). At year-end 2022, the top 10 made up 43% of the index value, up from 26% a decade earlier. The dominance of mega-cap stocks reached its apex in 2021, when the Russell 1000 Growth Index outperformed the small-cap Russell 2000 Growth Index by 25%—the widest performance margin between large- and small-cap stocks since the dot-com bubble.

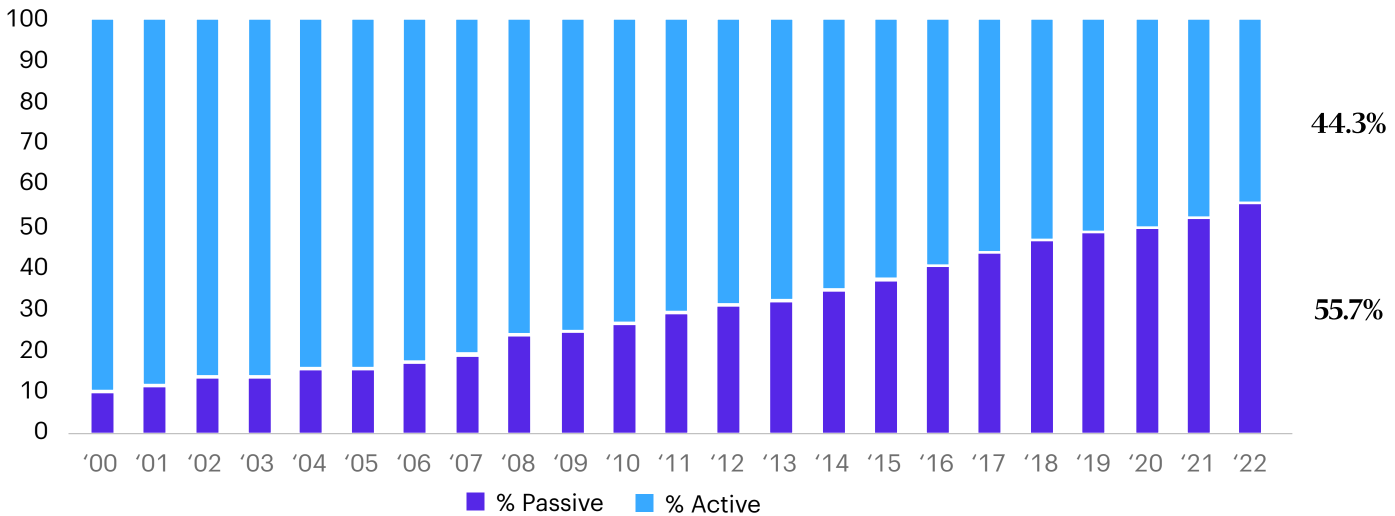
Momentum for passive investing fit hand-in-glove with growing name concentration over this period. Data derived from the Investment Company Institute show that $2.2 trillion flowed

1. Strategas Securities, LLC, Investment Strategy Viewpoint, January 27, 2023

into U.S. equity exchange-traded funds (ETFs) since 2009, and 83% of all new flows into ETFs have been directed to market-cap-weighted strategies.[1] Year after year, new allocations channeled flows to yesterday's winners. Over the same period, $2.8 trillion flowed out of U.S. equity mutual funds, where active managers still dominate. Currently, 45% of equity assets are held in active strategies and 55% are held in passive funds.

FIGURE 1: THE STEADY GROWTH OF PASSIVE INVESTING

% ASSETS IN ACTIVE V. PASSIVE FUNDS



Sources: Strategas and Investment Company Institute; data presented from 2000 through 2022

The strength of both of these trends made it very difficult for active growth equity managers to outperform their benchmarks. In fact, the Russell 1000 Growth Index outperformed 92% of all funds in the U.S. large growth category of Morningstar for the 10 years ending December 2022.

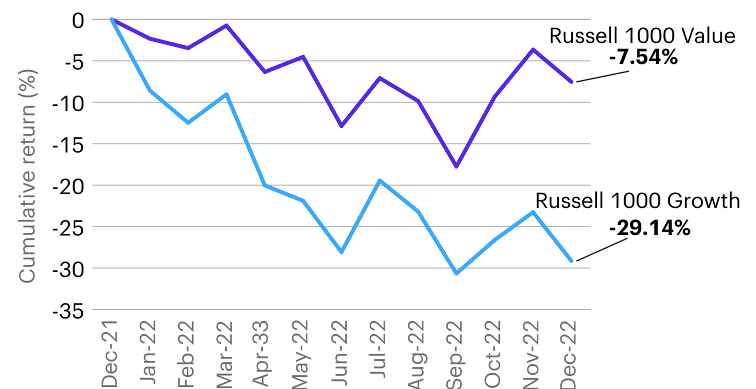
The unwind of 2022

The trends noted above were backstopped by central banks. However, a series of aggressive rate hikes that began in March 2022 have taken out this key pillar of support and damaged equity allocations in two ways.

The first was through the market's recognition of better total return opportunities in fixed income. Meaningfully higher bond yields have pulled capital away from equity markets at the margin. The second came from recognition that equity asset valuations are often highly interest rate sensitive. Distant earnings projections are now subject to significantly higher discount rates that compress valuation multiples. This de-rating is most pronounced across growth equities, where significant free-cash-flow generation is usually achieved much later in a company's life cycle than for the slower-growth companies that make up the value space.

The magnitude of the rotation out of growth stocks was on display last year as the Russell 1000 Value Index outperformed the Russell 1000 Growth Index by 22%—the largest margin in 22 years. The extent of value dominance is best summed up by a report from Credit Suisse: It found that low price/earnings (P/E) stocks in the S&P 500 Index outperformed high P/E stocks by 15.9% in 2022, the widest margin since 2000–2001 and the first time that low P/E stocks led in all 11 sectors in over 25 years. The trend was observed across all major indexes, styles, and regions but was most powerful among small caps and growth.

FIGURE 2: GROWTH UNDERPERFORMS VALUE; CUMULATIVE RETURNS IN 2022



Source: eVestment Alliance, as of December 31, 2022

Past performance is not a reliable indicator of future results.

The opportunity

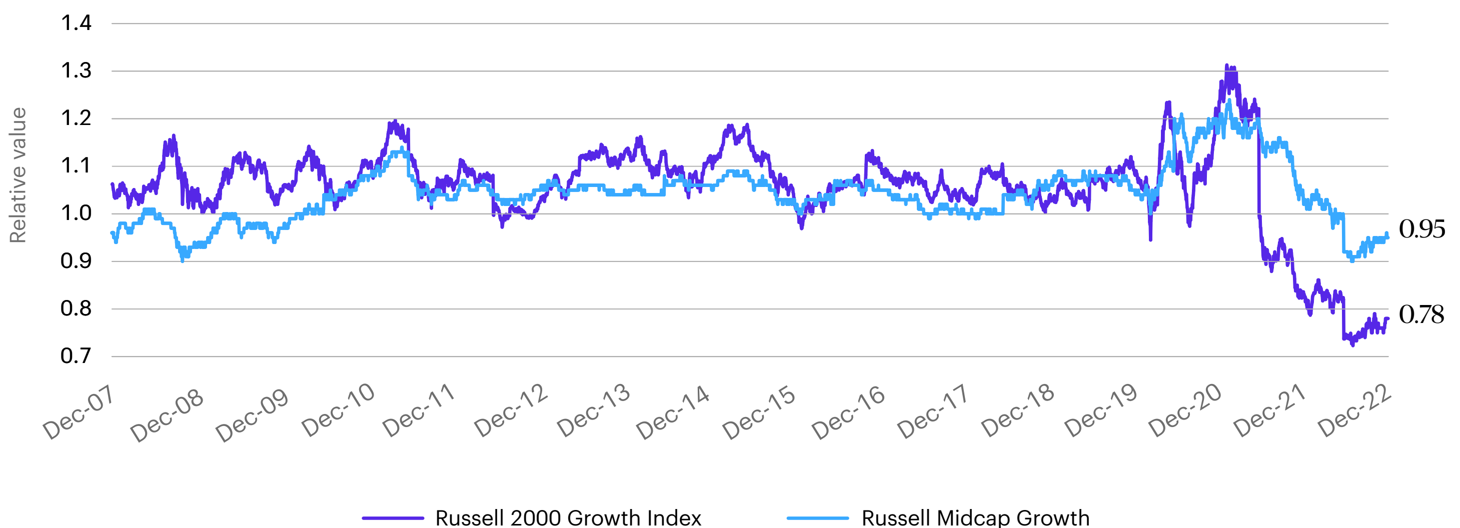
After the aggressive de-rating of growth stocks in 2022, we note three significant reasons for improvement in the outlook for investors in this asset class and for active approaches in particular.

VALUATIONS

The first reason for renewed optimism is probably the easiest to recognize. Much of the froth that characterized the growth stock universe in the past several years has dissipated and brought valuations back to pre-pandemic levels. From a relative-value perspective, we are seeing the most attractive opportunities down market cap. At the beginning of 2023, relative valuations of mid- and small-cap growth to large-cap growth stocks were, respectively, 9% and 27% below their median of the past 15 years. Their depressed relative valuations reflect years of small-cap underperformance—the Russell 2000 Growth Index underperformed the Russell 1000 Growth Index in 12 of the past 16 calendar years.

FIGURE 3: SMALL-CAP GROWTH AND MID-CAP GROWTH RELATIVE VALUATIONS ARE AT DECADE-PLUS LOWS

RELATIVE VALUATIONS OF MID- AND SMALL-CAP GROWTH TO LARGE-CAP GROWTH;
ENTERPRISE VALUE/EBITDA* (NTM**)



*EBITDA = earnings before interest, taxes, depreciation, and amortization
**NTM = next 12 months
Source: FactSet, as of December 31, 2022
Past performance is not a reliable indicator of future results.

BREADTH

The second reason for optimism comes from improving market breadth. A study we conducted early in 2022 examined the concentration cycle—the normal ebb and flow of name concentration—within large-cap growth equities from June 2001 through December 2021. At the time, we made two key observations:

- "Periods of increasing concentration and decreasing concentration have lasted an average of just under 5.5 years in this measurement period.
- The current period of increasing concentration has lasted longer than the average, and based on the deceleration we have seen of late, it would be reasonable to expect the beginning of a new cycle soon."

Our expectations of improved breadth have largely come to fruition, but we believe there is ample runway for further improvement. Small caps have historically made up over 7% of total equity market capitalization since 1930. Yet, at the beginning of 2023, small caps still represented approximately 4% of the market by value. The under-representation of mid-caps is similar; they have comprised 15% historically and currently represent only 11%. If history is a guide, small- and mid-cap companies have room to attract an outsized share of capital into a broad economic recovery.

While ongoing cyclical headwinds make a broad recovery far from certain near term, increasing breadth can help investors improve diversification among specific company growth drivers. This backdrop also presents a renewed opportunity for accretive stock selection.

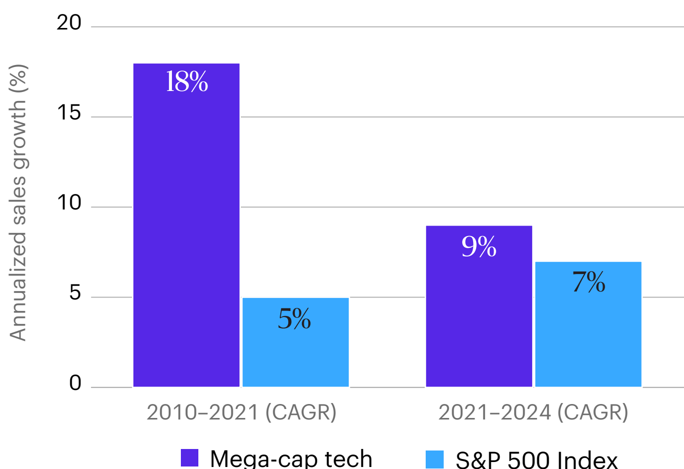
ACTIVE MANAGEMENT

A third reason for optimism stems from the ability of active strategies, which now represent a minority of capital deployed in U.S. equity markets, to capture value from passive investors who sustain market exposures to past winners. This includes market exposure to mega caps, which now face significantly lower projected forward growth rates.

An example can help clarify why active investors can benefit. Over the past 12 years, the four largest companies in the S&P 500 Index grew revenues at an 18% annualized growth rate, or 3x higher than the index as a whole. This compounded to over 600% growth in revenues over the period—an astonishing feat, but one that is unlikely to be repeated.

FIGURE 4: MEGA-CAP DOMINANCE WANES, BREADTH IMPROVES

ANNUALIZED SALES GROWTH; S&P 500 INDEX VERSUS MEGA-CAP TECH (AAPL, AMZN, MSFT, GOOGL)



CAGR = compound annualized growth rate; 2021–2024 (CAGR) contains forecasted growth rates
Source: Goldman Sachs Global Investment Research
Past performance is not a reliable indicator of future results.

At the end of 2021, the trailing 12-month revenue of these four companies was collectively $1.4 trillion, or about 6% of U.S. growth domestic product (GDP), which, at $23.3 trillion, represents the sum total of economic activity that took place on all of U.S. soil in 2021. The Bureau of Labor Statistics estimates the long-term U.S. GDP growth rate at 2.1%. If the historical revenue growth rates of these four companies were sustained for another 12 years, they alone would represent more than one-third of projected GDP in 2033! If that seems far-fetched to you, we share your sentiment.

The much more likely scenario is that growth rates of these and the other mega-cap companies, while still impressive in absolute terms, will slow meaningfully in the years ahead. As their dominance wanes, the opportunity for active managers to add value should improve—especially with companies down market cap, where relative valuations are more attractive and growth opportunities are not constrained by company size.

Conclusion

As painful as the market was for growth stocks in 2022, we know the best long-term investment opportunities arise during periods of turmoil. We can't predict an exact turning point, but we are confident that earnings estimates and valuations now reflect more realistic expectations. The days of selecting stocks based on one criteria—"how fast can it grow?"—are over in this more normal discount rate environment. In the years ahead, we expect sustained higher returns on equity and returns on invested capital to support growth stock valuations. In any ensuing economic recovery, growth should be slower in a higher interest rate environment. This backdrop should support a scarcity premium for high-growth companies.

The Dynamic Growth Equity investment process targets companies that exhibit what we call "pure growth." These companies produce top-quartile growth in their respective industries and rely heavily on secular growth drivers. This means that we look for companies that can support earnings, profit margins, and free cash flows organically, without the aid of cyclical tailwinds, and we seek such companies across the capitalization spectrum and across economic sectors. We believe the result is a better-balanced portfolio that represents the best of what U.S. growth equity markets offer. Investors would be well served to take advantage of the market opportunity to position their growth allocations for success in the years to come.

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