Newsletter
Fundamental Growth and Core Equity

April 2021

Investing in Sustainable Growth

A Focus on Quality

STATE STREET GLOBAL ADVISORS

Contents

A Focus on Quality Fundamentals

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Against the backdrop of shifting economic and market conditions, the nature of the post-COVID landscape is beginning to be glimpsed. Change may be in the air, but the importance of maintaining a long-term focus on investing in quality companies with durable competitive advantages remains intact.

The economic recovery gathered momentum in the opening quarter of 2021, albeit at a pace that varied by geography as the pandemic remains far from over. COVID-19 cases appear to be rising again in many places, with new more resilient mutations increasingly prevalent, while the extent of vaccine rollouts vary greatly globally. Nevertheless, the global economy is on pace to expand at a faster rate than we've seen for many years. The US, in particular, is in resurgent mode, as recovery is being bolstered by a new massive $1.9 trillion stimulus program. The result is a cyclically-stimulated market.

Ten-year rates have risen sharply along with inflation expectations, although both appear to be well contained for now by historical standards. In terms of equities, this has driven a rotation toward value, cyclicals, and generally lower quality. Many of these companies were hit particularly hard during the pandemic and the progression to recovery mode has led to a rerating. Growth and high-quality stocks, which were viewed as 'safe havens' in the midst of last year's turmoil, have lost some of their luster as the recovery has gained momentum. This has resulted in a market that is less narrowly concentrated, which is a healthy development. Valuations remain on the high side, but this reflects strong earnings growth expectations that are continuing to be revised higher. While this leaves less room for error, these expectations appear rational given the many positive economic tailwinds. Investors are cautious, given the latest COVID wave, but the biggest concern may be an overheating economy that leads to earlier than expected central bank tightening.

As long-term investors, we strive to look past the day-to-day market rotations and macro worries, staying focused on forward-looking company fundamentals. We expect high-quality companies with durable competitive advantages to win over the long run. In our view, the secular trends underpinning many of our highest conviction holdings remain intact. This includes the proliferation of technologies such as cloud computing, big data, internet of things, and digitization through all corners of the economy. Another secular trend that we are focused on is the increasing awareness and response to climate change — How the market thinks about the environment and accounts for climate change is rapidly changing and will impact companies across industries.

We seek to identify companies that are well positioned to thrive in this new world by focusing on quality sustainable growth and reasonable valuation. One question we often get asked, is how we apply this approach to traditionally cyclical industries. In this newsletter, our research team will guide you through how we apply our investment process in areas such as materials, energy, and financials. Returning to the ESG theme, members of our technology team examine the frequently overlooked fact that digital innovation, and the companies that enable it, plays an important role in helping companies meet their ESG goals.

Selecting Quality Stocks in Cyclical Sectors

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Director of Research

The three pillars of the Fundamental Growth and Core Equity team's philosophy are quality, sustainable growth, and reasonable valuation. Within this framework, we have consistently identified high-performing stocks in high-growth industries supported by secular growth trends — such as e-commerce and software.

Although our equity portfolios are concentrated, we still seek diversification across industries; this raises the question of how and when do we invest in companies whose growth is more dependent on cyclical economic factors. This question is particularly topical at present, given the potential for economically-sensitive stocks to relatively outperform against the backdrop of the global recovery from the pandemic.

Unearthing Quality

Each element of our philosophy plays a role in our approach to investing during periods of economic recovery, but we will begin with quality. We define and measure quality through our Confidence Quotient (CQ) framework. Our analysts combine quantitative data with their domain expertise and judgment to make a forward-looking assessment of companies' ability to "sustain" growth over a three-to-five year horizon (at a minimum). Management, industry structure, pricing power, capital intensity, balance sheet strength, regulatory influence, ESG, and an extensive list of other factors complete the scorecard used to assess our confidence in the sustainability of growth. In essence, it is an assessment of our confidence in a company's future earnings potential, and thus helps us determine what we are willing to pay for that income stream.

Evaluating Quality — Confidence Quotient

CQ is our proprietary indicator of a company's quality and consists of our analysts' assessment on a 1 to 10 scale of the following characteristics:

Market Position — Sustainable Competitive Advantage

Management — Conviction in Leadership

Financial Condition — Strength of the Financial Model

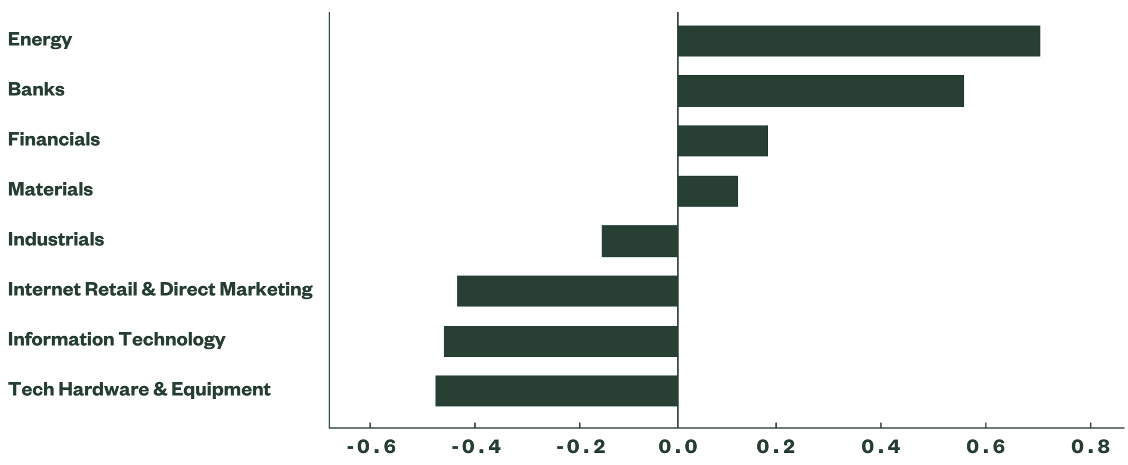
Transparency — Visibility of Business

Fundamental Momentum — Business Is Trending Positively

The assessment for each of these five areas is supported by a detailed scorecard of sub-measures, which are also ranked on the 1–10 scale. Included in the sub-measures are Environmental, Social and Governance (ESG) criteria, which are an important part of the CQ analysis.

With that background in mind, the sectors with the highest degree of cyclicality are financials, energy, industrials and certain materials companies (gold companies are the exception). These sectors are positively correlated to rising interest rates (Figure 1), which generally rise as economic growth accelerates. The business models of companies in these sectors are often more volatile, illustrated in part by higher sector betas. As such, they generally have lower CQ scores because we have less confidence in our ability to predict their growth rates and their return potential. Over the years, we have selectively identified opportunities in these sectors, however, and the following examples illustrate our process at work.

Figure 1
MSCI World Select Sector Correlation with Nominal 10-year US Treasury Yield



Source: Bloomberg Finance L.P., MSCI, as of March 3, 2021, based on daily data points. Banks are a sub-index of Financials; Internet Retail & Direct Marketing is a sub-index of Consumer Discretionary (not shown); and Technology Hardware & Equipment is a sub-index of Information Technology. Past performance is not a guarantee of future results.

Key Considerations in Energy and Materials

Commodity prices are set by the market, leaving companies operating in these sectors as price-takers. The industries are fragmented, with new projects generating sizeable increases in supply. Quite often, the companies are partially state-owned, prioritizing job creation, and thus supply, over profit. Capital intensity is high given that resources are a depleting asset, requiring ongoing investment to maintain production. Returns on capital, for energy in particular, have been poor over the last decade, as have total returns to shareholders.

ESG (economic, social, governance) factors, which are integrated into the CQ analysis, present an additional risk — there are numerous examples of environmental and community disasters, labor disruptions and injuries throughout history, as well as government and regulatory unpredictability. Predicting such events is naturally very difficult, yet we know they happen. As a result, most companies in the sectors score poorly on our CQ metric and are unappealing to us at any price. But there are always exceptions.

Iron Ore and the China Factor

In the early part of the last decade, we recognized that China was experiencing explosive growth in infrastructure and urbanization. This was well before it became a consensus call and was partly driven by our collaborative culture and the input of our China and emerging markets teams. Further research helped us identify the iron ore industry as having the attributes we look for when scoring companies.

- Three companies dominated the industry
  - — Effectively controlling supply, providing visibility.
  - — Setting prices annually.
- Superior assets, meaning:
  - — High concentration of ore per ton mined which lowers mining costs.
  - — High reserve lives brings certainty of production and lower exploration costs.
  - — Relatively fewer impurities — attractive to China to blend with domestic ore to make quality steel and reduce emissions.

These attributes gave us high confidence in the long-term earnings power of these companies, something the broader market underappreciated relative to other miners at the time, thus completing the mosaic along with attractive valuations. After a long period of time and extraordinary returns, valuations became less attractive, China's demand growth slowed, and new supply caught up with demand. Our analysts lowered CQ scores to reflect these changes and we eliminated positions.

The Opportunity in Building Materials

More recently, Martin Marietta Materials (MLM) has been a preferred holding in the materials sector, a company we highlighted in a previous newsletter. MLM's primary business is in aggregates, which are used in highways, infrastructure, commercial and residential construction. It will certainly benefit from an economic recovery, which typically underpins the housing market, while the potential passage of an infrastructure spending bill offers further support. But why would we own this company ahead of other names in the sector?

- MLM's broad network of quarries in geographies experiencing strong growth due to demographic shifts is driving demand for its products.

- High transport costs for heavy materials enables pricing power for locally-based producers as switching options are limited.

- Natural stone has unique properties that make substitutes difficult; as the cost of stone in an overall project is generally small, customers tend to be relatively insensitive to price.

- Barriers to competition are high — opening new quarries is difficult, given a shortage of stone resources and high regulatory and environmental hurdles.

- MLM management has proven skilled at identifying strategic assets for acquisition, executing on integration and extracting synergies.

These metrics, captured in our CQ analysis, manifested in strong historical performance and particularly recently in anticipation of the economic recovery.

Financials Sector — Focusing on More than Rates

Financials share many of the attributes of the mining and energy sectors — fragmented industry structure, potential disintermediation from new entrants, significant government/regulatory intervention, and dependence on exogenous cyclical factors like interest rates. We are not interested in the many low CQ stocks in the financial sector, but we have identified relatively attractive investment opportunities with sustainable growth.

Two financials that drew our attention are First Republic Bank and SVB Financial Group (Silicon Valley Bank). These companies:

- Serve niche markets that benefit from secular growth trends in the innovation economy and high net worth segments.

- Have unique service offerings, which help drive sustainable growth.

- Have strong management teams that consistently delivered on capital allocation and strategic initiatives.

- May be less dependent than other banks on rising interest rates, but the benefit of steady growth drives the longer-term compounding of shareholder returns that we seek.

Other areas in the financials sector that exhibit these consistent growth characteristics include data providers like the London Stock Exchange, S&P Global, and CME. They have platforms that clients depend on and are difficult to replicate. Significant revenue is driven from subscriptions, which are recurring and frequently increase annually, with clauses that provide a natural hedge against inflation. Data needs and, increasingly, analytics will likely continue to drive growth for these companies well into the future. Regulatory risks are present, but are lower than for the wider sector. As long as these dynamics are in place, which sustain the high CQ scores, and valuation is not excessive, we expect to realize the benefits of compounding growth with these investments.

Industrials Sector — Opportunities in Any Cycle

Within industrials, many companies have business models with relatively long-term attributes and excellent management teams. Solutions orientation, recurring service revenue contracts, oligopolies, etc., which all translate into pricing power, are some of the shared characteristics. An illustrative example is United Rentals (URI), a US company with high cyclical exposure, but one where we had a differentiated view relative to consensus.

Our research identified a long-term trend toward outsourcing of industrial equipment that the market viewed as cyclical, and thus undervalued the business model's evolution. Key attractions for us included:

- Renting, instead of owning, utilizes less capital for companies and avoids maintenance and obsolescence — United Rentals could drive higher utilization rates of the equipment through centralization.
- Industry consolidation has been led by URI and a similar UK-based company, Ashtead, who enjoy the benefits of being the dominant two players:
  - Equipment purchasing power increased as their businesses grew.
  - Diversification of regional and end-market exposure helped them to move products through their network to where they were needed most.

While high leverage was a concern reflected in our CQ framework, we had confidence in two countercyclical defenses. During downturns, less investment is required in the rental fleet, thus increasing cash flow, while weaker players would be shaken out of the market, ultimately leading to greater consolidation and scale. This, combined with the potential to increase rental penetration rates instead of owning, underpinned our confidence that the business was less cyclical than the market perceived, a view that was proven correct over subsequent years.

Conclusion — Disciplined Investment for Superior Returns

By scoring business models through our CQ Framework, we can compare business models across the globe in any sector. If sustainable growth trends can be identified in cyclical companies, such that their CQ scores, combined with attractive valuation, compare favorably to other sectors, we will allocate funds accordingly. By identifying the best combination of quality, sustainable growth and reasonable valuation, we believe we can deliver superior, consistent investment returns in various market environments. Even this one!

Company	**First Republic Bank**	**SVB Financial Group**	**Ashtead and United Rentals**	**Martin Marietta**
Sector	Financials	Financials	Industrials	Materials
Description	A US bank and wealth management company, catering primarily to high net worth segments in large cities on the west coast and northeast. Rare opportunity for secular growth in bank sector.	A commercial bank that serves emerging growth companies and the venture capital industry. Unique bank leveraged to the secular growth in the innovation economy.	Equipment rental companies, which operate networks of locations primarily in North America as well as the UK. Dominant top-two players in fragmented US equipment rental market.	Produces aggregates (crushed stone) for the construction industry. High quality business model with the ability to price above inflation.
CQ Score Highlights	Market Position: 8.0 Management: 8.0 Overall CQ: 7.4	Market Position: 8.0 Management: 8.0 Overall CQ: 6.8	Market Position: 7.4 (Ashtead), 7.2 (URI) Management: 7.7 Overall CQ: 7.2	Market Position: 7.8 Management: 8.0 Overall CQ: 7.3

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Information Technology: An Enabler for ESG

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Businesses are increasingly using digital transformation to improve their long-term competitive advantage and reach their sustainability goals. Information technology (IT) companies are at the center of the push towards digital transformation. While IT companies can also be seen as ESG investment opportunities, disclosures on key ESG metrics and goals will have to improve over time.

Over the last 20 years, the digitization of the media industry has disrupted this sector amid widespread adoption of the internet by consumers and enterprises. There has been a major shakeout that created winners and losers at a company level, while the digital transformation of the industry also delivered a positive environmental impact in contributing to an estimated 30% decrease in paper consumption per capita in the US between 2003 and 2019.[1]

Although the media industry was early in this process, other industries today see this digital transformation as a key enabler to improve their competitive advantage and achieve sustainability goals. Information technology (IT) companies are unsurprisingly at the center of this digital revolution, which represents a huge opportunity to strengthen customer relations, accelerate growth and strengthen the competitive edge of those IT companies that have sustainability and innovation at the core of their long-term strategies.

Adapting to Change

Many companies have moved digital transformation to the top of their strategic agendas — according to a recent Morgan Stanley CIO survey[2] it is a top three priority. Our own conversations with company CEOs over the last year suggest the impact of the COVID-19 pandemic to existing business models and value chains has accelerated the need for digital transformation and sustainability improvement. But, according to McKinsey, about 60% of the sectors of the economy are lagging in their digitization journey.[3]

The IT sector will be the enabler of digitization as companies scramble to catch up. For instance, firms are increasingly switching from single-tenant private data centers, where utilization rates are low, to public cloud centers that are used by thousands of enterprises at a time. This shift to cloud solutions results in an approximate 88% reduction of carbon emissions, according the Amazon,[4] and has a direct positive impact on customers' financials as they create and re-engineer business processes.

In a Verizon study, 77% of respondents stated that cloud technology gives their business a competitive edge.[5] Cloud technologies present inclusive solutions, with the latest innovations available to more than just sophisticated, large-budget enterprises; the significant lower cost means small firms can avoid being left behind by beginning their digital transformation early.

Embracing Tech Improves Environmental and Social Impact

Digital transformation is not just an opportunity for knowledge-based sectors like media, but also for more capital-intensive industries. For example, car manufacturers spend millions of dollars annually on physical car-crash testing, but simulation software from companies like Dassault Systems and Ansys digitize car-crash events. This can significantly reduce the number of cars wasted by hundreds, at a considerable cost saving per crash-test vehicle.[6] It also shortens safety design processes from months to weeks and increases the number of safety elements that can be tested. The end result is safer vehicles, with a direct impact on competitive advantages, financials and society (auto crashes account for approximately 2% of US GDP[7]).

Software vendor Adobe is another company selling solutions that help others improve their ESG footprint through digital transformation. Adobe's Creative Cloud solutions allow teams of designers to collaborate on projects across geographies, reducing the need for travel and thus reducing carbon emissions. Additionally, Adobe's 3D design technologies help companies replace photoshoots (which require physical products) with photo realistic designs, reducing the environmental impact of wasted products. Similarly, the cloud distribution of Adobe's software avoids unnecessary and environmentally-unfriendly manufacturing, packaging and delivery of physical software discs.

IT companies also facilitate financial inclusion — World Bank estimates that around 1.5 billion adults do not have access to financial services. In partnership with Ingenico (a payment services company), the Zambian government rolled out a biometric solution that links personal identification with farming activity to roll out agricultural subsidies for more than 190,000 farmers in rural areas where poverty rates are 77%. Visa and Mastercard also offer "push payment" technology by which government and employer payments are electronically delivered to their beneficiaries via debit cards. According to US Treasury data, approximately 3% of stimulus payments were issued by debit card as of June 2020, which is more efficient, more secure and gives the unbanked an avenue into electronic commerce.

Other software companies are enabling ESG solutions for customers. For instance, while SAP's core software expertise is in areas like ERP (Enterprise Resource Planning), SAP uses its strong expertise in ESG to develop the SAP "Sustainability Performance Management" software for customers looking to measure, manage and disclose their organizational performance towards the goal of sustainable development.

Information Technology as an ESG Investment Opportunity

The IT sector is an enabler for sustainability and can also be seen as an ESG investment opportunity as sub-sectors like software and IT services are not carbon-intensive and invest heavily in skilled workforces. For example, software provider SAP has been named the software industry leader in the Dow Jones Sustainability Indices for the fourteenth consecutive year. This is a result of embedding its sustainability program throughout its long-term business strategy.

As in other sectors, IT investors are looking for standardized disclosures by management teams in order to improve comparability and understanding of the impact of sustainability initiatives to their financials. Staying with the SAP example, the company estimated a 0.24% positive impact to SAP's operating margin for every 1% change in its greenhouse gas emissions.[8] Being able to estimate such an impact to profit margins for all companies would be helpful for investors. IT companies will improve and disclose standardized ESG metrics over time in areas like energy management, consumer privacy, data security, employee engagement and diversity, competitive behavior and systemic risk management — these are all areas which the Sustainability Accounting Standards Board (SASB) deems "material" sustainability factors for the IT sector. For instance, for a number of years SAP has disclosed its global carbon emission, energy consumption, data center electricity, e-waste and water usage.

IT companies like SAP (software), Tieto (IT services), Worldline (payment services) are examples in Europe of improved execution (50-100% of long-term carbon emission targets already achieved in 2019) and disclosure on sustainability factors. Other companies like SAP are going beyond initial internal environmental targets to now have a 2050 target of 85% reductions in CO_2 emissions along its entire value chain.

Closing Thoughts

Business leaders across the globe are seeing digital transformation as an enabler to strengthen their competitive advantages and achieve sustainability goals. Information technology companies that focus on innovation as a key part of their long-term strategy can convert the increasing importance of sustainability into an opportunity to accelerate growth and differentiate their offerings.

Technology companies are also looking to improve their execution and disclosure on sustainability targets. As investors look for ESG investment opportunities, sectors like software and IT services are attractive given their low carbon-intensive footprint. But targets and standardized disclosures on environment, social and governance metrics are still needed by investors to understand the financial and strategic impact of their sustainability initiatives.

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Endnotes

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* This figure is presented as of December 31, 2020 and includes approximately $75.17 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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