Insights
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Equity Investing: Sustainable Growth for the Long Haul

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Growth style equity investing has delivered strong gains over the past decade. Clients who have embraced both Value and Growth strategies in this time would have enjoyed healthy returns, albeit not as rewarding as a Growth-only approach, as the two offset to become closer to neutrality from a style perspective. However, those with an uncovered tilt toward Value have experienced this style's challenged performance against standard market cap weighted indices.

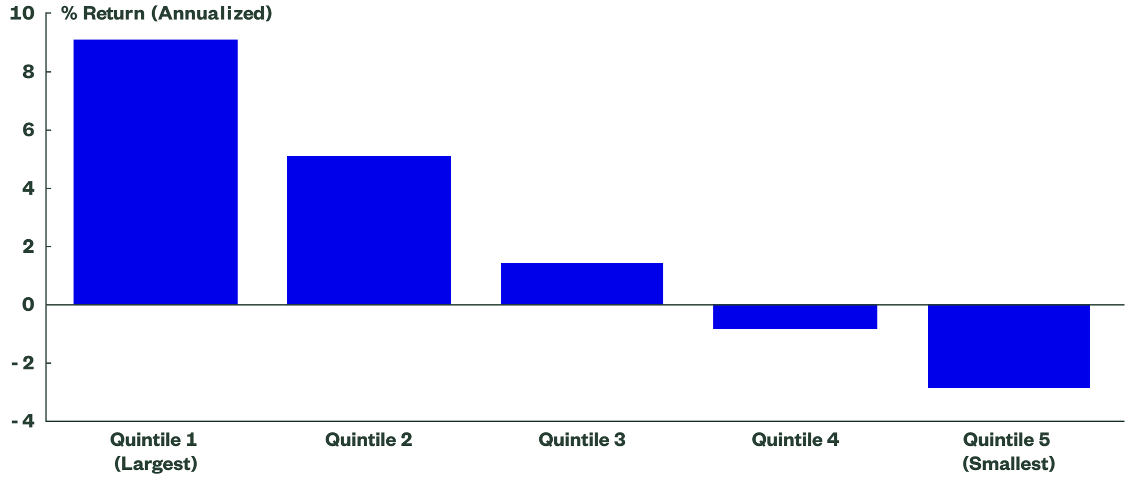
There are a variety of reasons that explain Growth's outperformance through the last 10 years. Most recently, there has been the tremendous outperformance by mega-cap stocks, most of which are not constituents of the Value style indices. This has led to investor concerns about high valuations, and questions over whether Growth can continue its run. We believe merging a quality perspective with growth characteristics will help to capture the *sustainable* growth profile that many long-term investors can benefit from.

Looking Beyond the Mega Caps

Over the last few years, there has been a pattern of outperformance down the complete capitalization size spectrum. As illustrated in Figure 1, the returns for each market cap quintile within the MSCI World Index since the end of 2017 reflect a consistent outperformance of larger-capitalized companies over stocks with a smaller market value. And that pattern is consistent down the whole spectrum. If performance was dominated only by the mega caps, you would expect to see the largest quintile with strong performance, with the rest of the quintiles having mixed results. So, while the FAANGS[1] and other mega-cap acronyms get much of the attention, the size effect doesn't just stop there; it continues throughout the whole universe.

Figure 1

Market Cap Quintiles Annualized Returns (31 Dec 2017–30 Sep 2020)



Source: State Street Global Advisors, FactSet, MSCI as of 30 September 2020. Past performance is not a guarantee of future results.

Projecting this large-cap outperformance shows its implication on style investing. Figure 2 shows just how dramatic the change in the market cap profiles of the MSCI Value and Growth indices has been. The median market cap of MSCI World Growth is now 30% greater than that of the MSCI World Value. Linking this to the performance pattern discussed above, Value's underperformance and Growth's outperformance isn't just about the FAANGs. At the midpoint, the Growth index is larger than Value, and since larger caps outperformed lower caps down the spectrum, this has proven to be a strong tailwind for Growth.

Figure 2a

Median Market Cap

MSCI World Value

MSCI World Growth

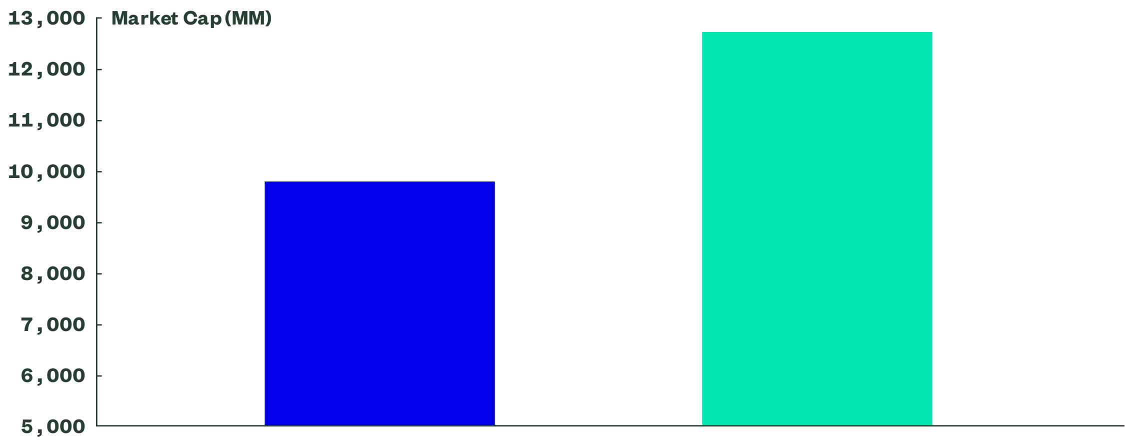
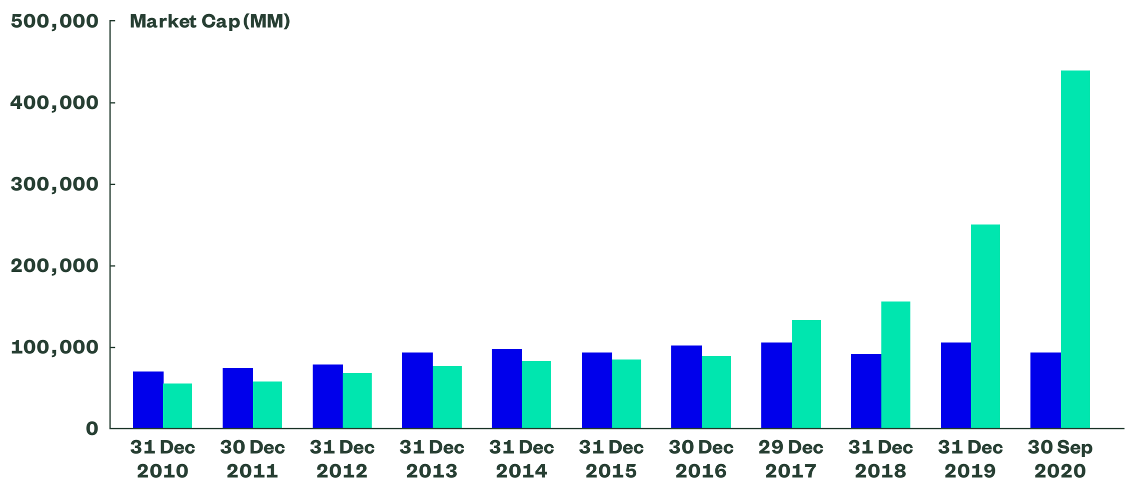


Figure 2b

Weighted Average Market Cap

MSCI World Value

MSCI World Growth



Source: State Street Global Advisors, FactSet, MSCI as of 30 September 2020. Characteristics are as of date indicated and shouldn't be relied on thereafter.

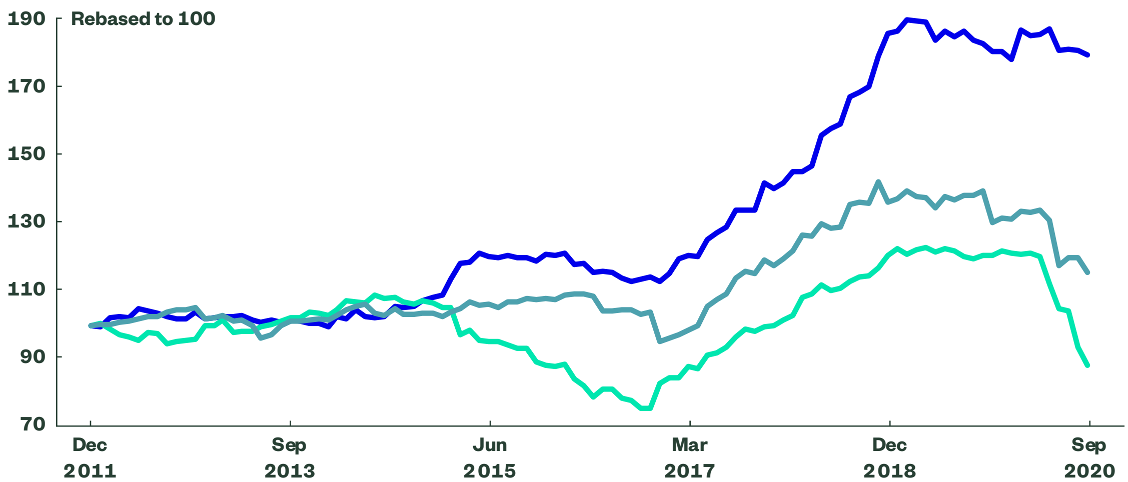
Since 2016, the weighted average market cap of the Growth index has almost quintupled to about $500 billion, while the corresponding figure for Value has actually fallen slightly. In the first half of the 2010s, similar-sized companies were represented in both the Value and Growth indices. However, there has been an explosion in the market cap profile within the Growth index. This is just one example of the momentum that we've consistently seen within the Growth part of the equity universe. It begs the question: why have these large-cap growth companies continued to grow so explosively?

Is Growth's Surge Justified?

If we step back and take a look at the bigger picture, it is undeniable that the growth indices have a long-term secular and structural advantage. Growth is relatively overweight the information technology sector, along with many technology-enabled companies in other sectors that are well positioned for the future. As at the end of September 2020, the weight of the technology sector in the MSCI World Growth index stood at 34%, but the corresponding exposure was only 8% in the MSCI World Value index. It's well known that technology increases productivity, creates efficiencies and cost savings, and exponentially expands innovation. Logically, it seems reasonable that those companies reaping the most benefits from their technology investments are growing. The challenge for investors is determining whether the recent outperformance is based only on future expectations of earnings growth, or if there is evidence that they have actually delivered on such elevated expectations.

Figure 3
Diverging Earnings Per Share Performance

MSCI World Index/ Information Technology
MSCI World Index Value
MSCI World Index Growth



Source: State Street Global Advisors, FactSet, MSCI as of 30 September 2020. Past performance is not a guarantee of future results.

Figure 3 provides us with a snapshot of how last twelve months earnings per share (EPS) growth has changed over time. Taking the technology sector EPS as an example, we can certainly see why the Growth index, with its higher technology weighting, has superior EPS growth compared to the Value index. High earnings growth is desirable and is worth more of a premium.

Combining Characteristics for Long-Lasting Growth

Up to this point, we've focused on the Value versus Growth argument, and reflected on why the strength of Growth has been justified. However, there is a range of underlying characteristics across the Growth universe, some of which are appealing, and some of which are not. Combining desirable characteristics within a growth universe may serve to increase the probability of investment success, and could outperform investment in "Growth" alone.

We find that one area where added value can be created is in the combination of both growth and quality characteristics. A view on quality helps to determine how well a company operates both internally (e.g. expense control, scale-up of operations) and externally (within a competitive landscape). Combining these two characteristics allows for a longer-term sustainable growth profile, while avoiding what could be short-term growth traps.

Figure 4
Intersection of Growth and Quality Offer Greatest Probability of Success
MSCI World Index (USD)
31 Dec 2009 to
30 Sep 2020

	ROE Quintile 1	ROE Quintile 2	ROE Quintile 3	ROE Quintile 4	ROE Quintile 5	Total
	Total Return	Total Return	Total Return	Total Return	Total Return	Total Return
Total	13.58	11.24	6.51	3.65	1.99	8.96
3 Yr Earnings Growth (hist) Quintile 1	16.04	16.09	9.27	5.96	6.77	13.07
3 Yr Earnings Growth (hist) Quintile 2	14.78	14.21	10.01	4.02	3.30	12.46
3 Yr Earnings Growth (hist) Quintile 3	14.41	8.70	7.96	7.80	1.63	10.72
3 Yr Earnings Growth (hist) Quintile 4	10.68	7.61	4.28	4.17	4.37	7.32
3 Yr Earnings Growth (hist) Quintile 5	8.98	5.39	1.02	1.40	-0.15	3.22

Source: State Street Global Advisors, FactSet, MSCI as of 30 September 2020. Past performance is not a guarantee of future results.

In Figure 4, we use a simple single metric to represent both Growth (3 Year Earnings Growth) and Quality (Return on Equity). We break the global developed MSCI World index into five quintiles and show the annualized 10-year return for each intersection. The results tell us that a combination of the highest quintiles of both growth and quality (the intersection of quintiles 1 and 2 of each) is better than solely investing in the highest growth or highest quality quintile companies alone. This illustrates why we view this intersection of growth and quality as extremely powerful and the best target area — the hunting grounds — that gives an investor the highest probability of future success.

The State Street Global Advisors Approach

At State Street Global Advisors, our Fundamental Growth and Core equity team utilizes an investment philosophy united by a common belief — **that quality companies with sustainable growth at attractive valuations** can drive above-average investment returns over the long term. Looking beyond the horizon of the average investor, we find that companies with durable competitive advantages are frequently undervalued relative to their compound growth potential. This creates alpha opportunity.

We assess companies on the quality traits that we believe are associated with long-term sustainable growth. We seek to identify companies with strong competitive positioning, are in solid financial condition and have proven management teams that create repeatable fundamental prospects.

Our approach is fundamental and bottom-up and is characterized by process discipline and high conviction — traits that we believe are necessary for alpha generation. We look for growth that is durable, not based on momentum or unproven business models, while being sensitive to valuations. As a result, we can find attractive investments across the style spectrum. It is worth stressing that our focus on quality and sustainable growth is not the same as factor-based investing. Our definition of Quality is forward-looking and focused on qualitative attributes that we believe will lead to **sustainable growth**. We have concentrated and high active share portfolios, and most of our alpha and risk are **stock specific**.

Conclusion

Growth has enjoyed a strong run through much of the past decade. More recently, the strong large cap performance, not only by the FAANGs, has helped extend Growth outperformance versus Value indices. The earnings growth realized by these structural long-term themes have raised their premiums along with future expectations. By combining both growth and quality characteristics, investors may avoid short-term unsustainable growth traps and be better positioned for long-term success.

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Endnote

1 Facebook, Apple, Amazon, Netflix, Google.

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* This figure is presented as of September 30, 2020 and includes approximately $80.51 billion USD 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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