Insights
Fundamental Growth and Core Equity

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A Case For: US Premier Growth Strategy

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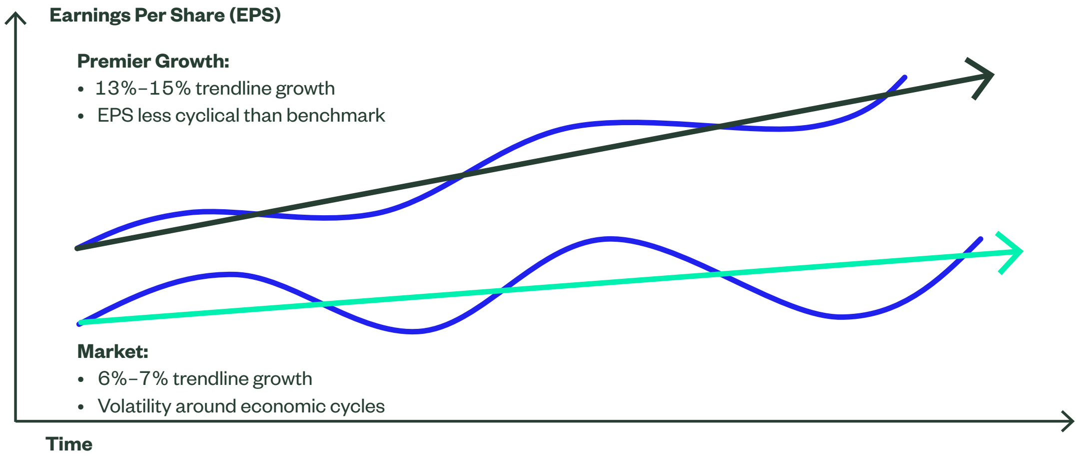
- US growth stocks have enjoyed a strong run and we believe there is further upside potential over the long term, particularly for high-quality innovative names.
- We believe that an actively-managed approach that targets companies with durable competitive advantages that trade at a reasonable valuation can generate alpha for the astute investor over the long term.

Looking for Sustainable Growth

Investing in US growth stocks has proved particularly rewarding, and this is even more so the case relative to value stocks over the past decade or so. Such a prolonged period of outperformance versus value has prompted many to question whether they should be investing in growth stocks at this point in time. But to reduce the argument to one of time rather than substance is to miss the point — the length of past relative outperformance is largely immaterial to the opportunities in the growth space at present.

Is it a growth or a value market? The Fundamental Growth and Core Equity team does not try and second-guess the short-term style preferences of the market and doesn't think investors are well served in trying to do so either. We believe that growth companies in the United States offer many dominant, high-quality, innovative, asset-light business models capable of compounding strong double-digit sustainable growth at very high returns on invested capital. The US equity market, especially growth stocks, provides access to some of the world's most innovative companies in the semiconductor, software, medical technology, internet services, ecommerce, robotics and industrial automation sectors, to name but a few. Many of these operate on a global scale, driving improvements in operating leverage, returns, and free cash flow generation — and resulting in increased capital for companies to reinvest in further innovation that enhances their competitive advantage.

Figure 1
US Premier Growth Strategy: Higher Growth, Less Cyclical



Source: State Street Global Advisors. For illustrative purposes only.

In our view, investors should have an allocation to US growth equities because we believe this area of the US market offers potentially the greatest long-term opportunities for capital appreciation — something that is not as readily seen in other asset classes, styles or geographies. Unfortunately, this part of the market also contains companies with unproven business models or high leverage, fad stocks that can fall as fast as they rise, and sky-high valuations that create massive downside risk. Without a doubt, it pays to be selective when investing in this segment.

US Premier Growth Equity Strategy

State Street's US Premier Growth Equity Strategy is an all-weather growth strategy centered around quality growth at a reasonable price principles. It is not just a collection of high-growth momentum names that are the mainstay of many other portfolios in the category. After a strong run by the Russell 1000 Growth Index, we believe our discerning approach is a better way to harvest the opportunities among large- and mid-cap growth equities in the US. This strategy depends not on style momentum, but instead on the ability of its holdings in aggregate to compound at a mid double-digit rate throughout the economic and market cycle.

Valuation Discipline Underpins Approach

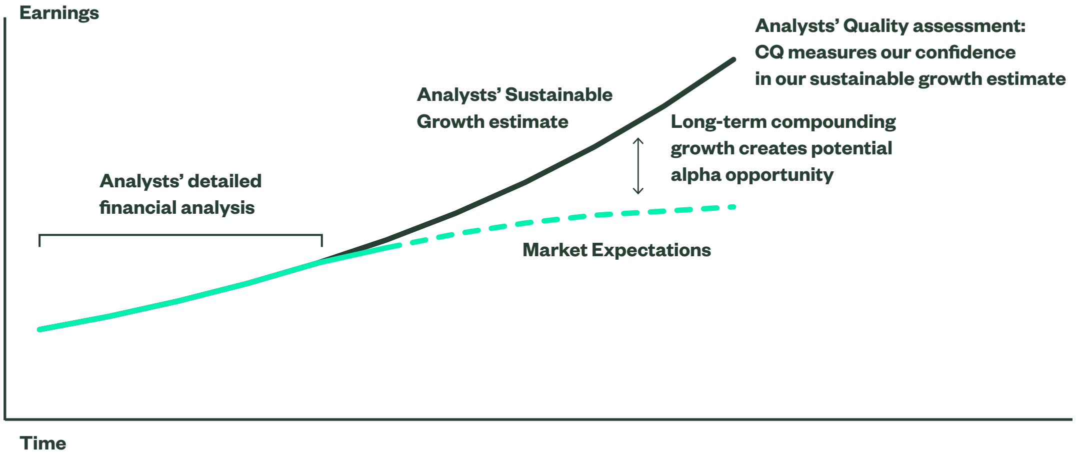
Attempting to time market valuation swings and sentiment changes is a notoriously difficult job for investors. Our valuation discipline underpins the portfolio strategy that aims to keep up with or beat the benchmark in strong 'up' years while providing downside protection during market corrections. We do this by investing in a concentrated collection of high-quality companies offering consistent, largely secular, mid double-digit aggregate earnings growth at reasonable valuations. We believe the strategy is not only an excellent way to participate in exciting long-term growth opportunities but is also a relatively secure port in a market storm.

Our concentrated US Premier Growth Equity Strategy has historically offered a three-to-five-year earnings per share (EPS) growth rate in line with or better than the Russell 1000 Growth Index,[1] but the aggregate price-to-earnings (PE) multiple has been substantially lower than that of the aforementioned benchmark. Additionally, the Premier Growth Equity strategy has in recent years had a lower standard deviation and beta than the benchmark, further reflecting relatively lower risk and volatility.

Portfolio Construction: Adopting a Longer Horizon

In constructing the portfolio, we apply a rigorous bottom-up approach to unearthing quality sustainable growth companies that trade on reasonable valuations. We seek companies that can reliably compound their earnings at a minimum 10% rate over the following three-to-five years. Most sell-side analyst models only go out three years, and some for even shorter periods, and conservatively assume a natural fade in growth and returns. This means that if we can identify companies that can sustain growth beyond this short horizon, they are likely to be undervalued by the market, as illustrated in Figure 2.

Figure 2
Long-Term Compounding Growth Creates Potential Opportunity



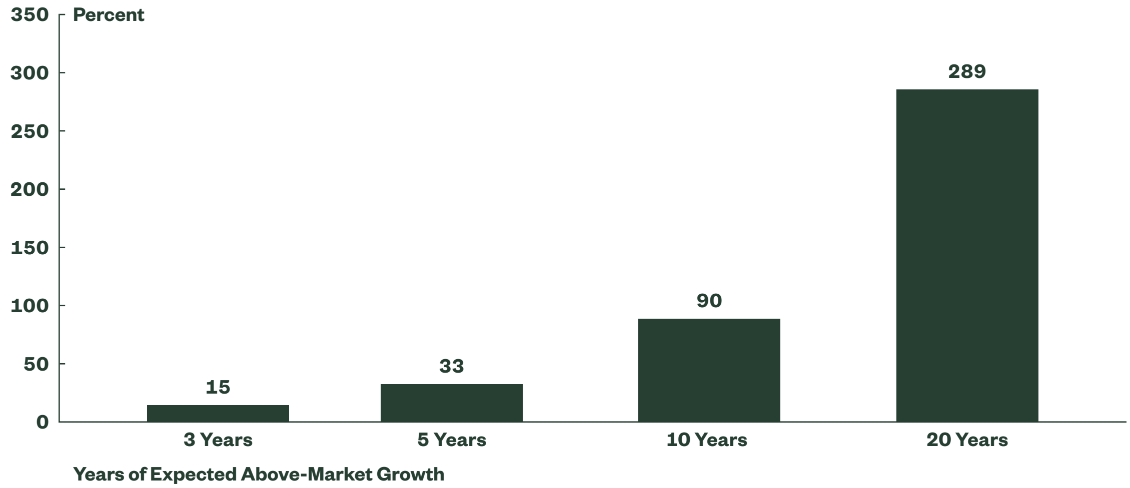
Source: State Street Global Advisors. For illustrative purposes only.

Identifying Opportunities: The Confidence Quotient (CQ)

How do we unearth such undervalued companies? After intense fundamental analysis and proprietary modeling we score each name on our proprietary Confidence Quotient (CQ) framework. This is unlike traditional measures of quality that emphasize a simple combination of historical returns, earnings volatility and debt. Instead, we define quality on a forward-looking basis and focus on qualitative measures such as the competitive moat, our confidence in the management team, the appropriateness of the capital allocation strategy, the transparency of the business model and the fundamental momentum of the business drivers. We leverage our long-tenured research team (with an average of 20+ years of experience) to quantify these "soft" metrics using our detailed CQ framework. The higher the CQ score, the higher our conviction in our projection of the duration of growth, creating substantial stock outperformance potential as compounding growth is realized over time. The sustainability of growth is key and we spend a lot of our time on this because the market often undervalues high growth that is truly sustainable — for example, by using simple near-term PE multiples on one-year forward earnings.

Figure 3 shows the premium to the market that durable growth is worth. In this hypothetical example, the valuation premium warranted to the market rises exponentially as the number of years of excess growth increases. We expect the strong quality attributes found in our high CQ companies will lead to steady predictable earnings growth, while our valuation discipline provides downside protection as the growth compounds.

Figure 3
The Market Often Undervalues Persistent Growth
Justified Market Premium for Different Durations of High Growth



Source: State Street Global Advisors. For illustrative purposes only.

Prospects for US Growth Stocks

US equity investors have enjoyed many years of strong growth, and the low interest rates and easy money over the past decade have resulted in stretched valuations in certain areas of the market. We think this will change as the economy, markets, and rates normalize, leading to less correlation and unidirectional movement that results in a better environment for active fundamental stock pickers like ourselves. Many high-growth firms, especially in the technology sector, fail or are disrupted. As beta and momentum decline as leading market drivers, the benefits of an experienced disciplined team to select your stock exposure becomes clearer.

In recent years, multiple expansion has been a big contributor to total return, especially for long-duration high-growth equities. However, with interest rates under upward pressure due to strong economic growth from the post-pandemic reopening and higher inflation, multiple expansion will be less likely going forward. In fact, high-multiple names are more likely to experience contraction through such a period, while the sustainable mid-teen growers at reasonable valuations that we hold in the US Premier Growth Equity strategy don't need multiple expansion for their stocks to advance. That, combined with our valuation discipline, should provide some ballast compared to our momentum-oriented peers who will be more likely to suffer significant multiple compression in a rising rate environment given their greater allocation to previously high-flying stocks.

A Portfolio of Innovative Long-Term Potential Winners

In summary, we aim to consistently compound our portfolio over the long run by investing in quality companies with sustainable mid-teens growth and consistently high returns on invested capital that trade at reasonable valuations. Our approach is aimed at giving clients a portfolio of innovative long-term winners that we expect to provide excess returns while at the same time providing downside protection because of our valuation discipline and deep emphasis on quality.

Endnote

1 Source: State Street Global Advisors, Bloomberg Finance L.P., as of 30 November 2021.

About State Street Global Advisors

Our clients are the world's governments, institutions and financial advisors. To help them achieve their financial goals we live our guiding principles each and every day:

- Start with rigor
- Build from breadth
- Invest as stewards
- Invent the future

For four decades, these principles have helped us be the quiet power in a tumultuous investing world. Helping millions of people secure their financial futures. This takes each of our employees in 30 offices around the world, and a firm-wide conviction that we can always do it better. As a result, we are the world's fourth-largest asset manager* with US $4.14 trillion† under our care.

* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of December 31, 2021 and includes approximately $61.43 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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