JUNE 2017
Thought Leadership

New Equity Regime
Advantaging Growth & Active Management

More Room To Grow

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"Big Growers remain attractive versus both Value and Growth as a whole"

After eight years of economic expansion and equity markets hitting new all-time highs on a regular basis, we are frequently asked:

- Is there more upside to go?
- Are equity valuations stretched?
- Will rising rates challenge valuations?

We firmly believe ...

- There is more room to grow.
- While in general equity valuations appear full, "Big Growers" remain attractively valued even following the first half of 2017 (Exhibit 1).
- Rising rates mark the end of the Quantitative Easing (QE) Era and a regime change in equity leadership has begun that we feel will advantage growth equities and active management.

Winslow Capital's investment philosophy and process has delivered strong, long-term results. Most important, these results have been generated with above industry average consistency. However, industry results have been challenged during the period following the Financial Crisis, during the era known as "QE", or Quantitative Easing. Fortunately, our work now concludes that we are entering a nearly ideal regime, an environment for our discipline.

Exhibit 1
Valuations for Growth Equities Remain Below Average

Growth is cheap relative to value... and growth is cheap relative to growth

Big Growers Ratio of Forward P/E versus Value Universe
Average: 2.4x Current: 2.0x

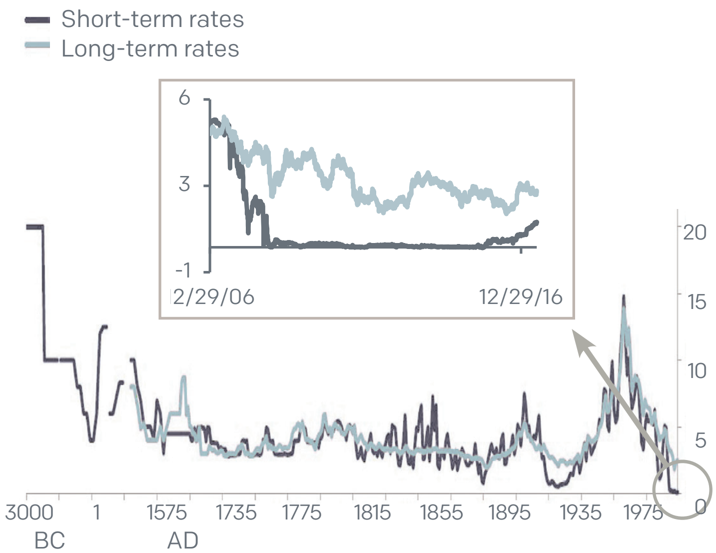
Big Growers Ratio of Forward P/E versus Growth Universe
Average: 1.6x Current: 1.3x

Source: Empirical Research Partners Analysis, National Bureau of Economic Research from 1976-June 2017. Big Growers are the approximately 80 securities with the best growth characteristics based on factors such as the level and consistency of their growth rates, ability to self-fund that growth, and valuation.

Exhibit 2 displays what happened during the QE-Era. Interest Rates hit 5,000-year lows during the summer of 2016. During this time, one third of all Developed Market sovereign debt in the world traded at negative absolute rates, 100% of all Developed Market sovereign debt in the world traded at negative real rates, corporations in Europe were issuing negative interest rate bonds and some European banks actually started charging interest on their depositors.

Exhibit 2

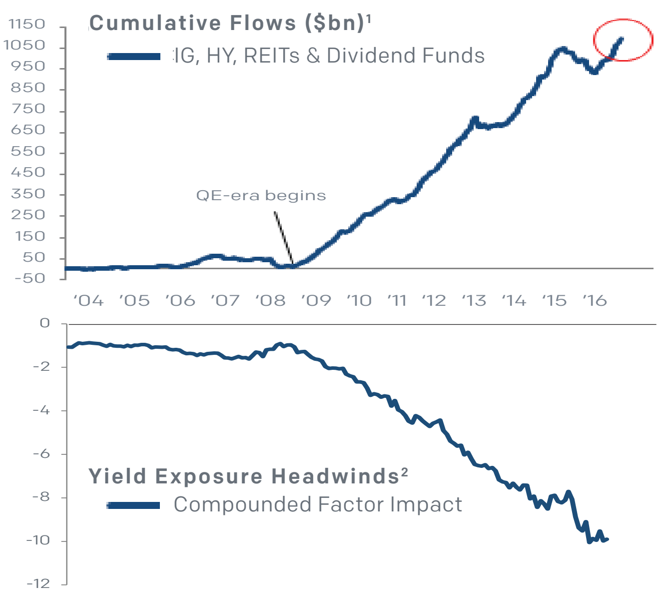
Bond Bubble: Interest Rates Near 5000 Year Lows



Sources: FactSet as of 6/30/2017. Homer and Sylla (1991); Heim and Mirowski (1987); Weiller and Mirowski (1990); Hills, Thomas and Dimsdale (2015); Bank of England; Historical Statistics of the United States Millenial Edition, Volume 3; Federal Reserve Economic Database.

Exhibit 3

QE-Era "Yield Trade" Headwinds

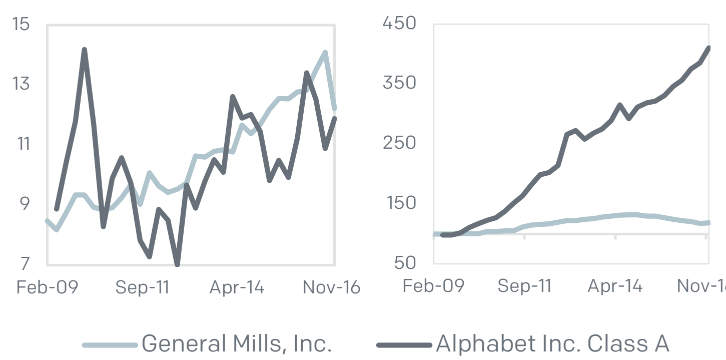


Source: 1. Source: BofAML Global Investment Strategy, EPFR Global, as of 9/28/16. 2. Source: FactSet and Barra as of 12/31/16

This environment, a first in recorded history, had a dramatic impact on the financial markets. During the QE-Era, money flooded into every asset class in search of yield. Assets with big yields were aggressively sought after while assets with below market yields were often indiscriminately sold. For true growth investors like Winslow Capital, the historically modest headwind of our portfolio's lower dividend yield became a tsunami, as demonstrated by Exhibit 3. You may note these charts are essentially mirror images of one another. Investment dollars blindly pursued yield and the yield-factor headwind became nearly impossible to overcome.

The effect of this environment and the thoughtless sale of the best growth assets to fund the purchase of higher dividend payers led to severe price dislocations across the market. There may be no better example than the relative valuations of General Mills vs. Google (Alphabet, Inc.) last summer following the Brexit vote, shown by Exhibit 4. In spite of Google's obviously superior fundamentals, General Mills' Enterprise Value to EBITDA valuation actually traded at a more than 35% relative premium to that of Google.

Exhibit 4



Source: FactSet as of 11/30/2016.

In this incredibly unique environment, the impact of the bond-bubble spilled over into the equity market, altering the pricing mechanism from fundamentals to yield. Not since the Tech bubble had an investment fad, meaning the "Yield Trade", caused such distortions in the pricing of equities. During calendar year 2016, the Highest Yielders within the Russell 1000® Growth Index outperformed the Lowest Yielders by 1500 bps and the Lowest Earning Per Share Growers within the index outperformed the Highest Earning Per Share Growers by 1100 bps. This combination of the markets focus on yield, irrespective of earnings growth, drove the abysmal results of active managers. During calendar year 2016, 93% of active Large Cap Growth managers underperformed the Russell 1000 Growth index by an average margin of -530 basis points. These results were the worst in history and Winslow Capital had its most challenging year as well.

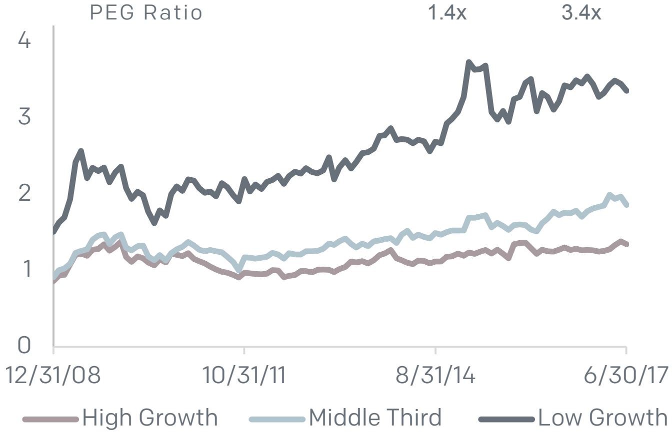
Remarkable Opportunity

While these investment results were disheartening to say the least, there were reasons for optimism. The vast majority of our underperformance was environmental, not fundamental. Actually, the fundamental perspective of the companies we owned in the portfolio remained very compelling. During calendar year 2016, more than 80% of the companies we owned in the portfolio beat street consensus and delivered a positive earnings surprise. Those results ranked ahead of our teams' long-term historical average.

This environment created an unprecedented opportunity. As discussed earlier and demonstrated in Exhibit 1, not only had Growth become cheap relative to Value, but the very best Growth companies had become cheap relative to Growth as a whole. At year-end 2016 the relative valuation for these "Big Growers" was near 40-year lows. Below is another way of analyzing this phenomenon. We broke down the Russell 1000® Growth Index into three tranches: High Growers which tend to have relatively low yields, Low Growers which average higher yields and the Middle Growers. Driven by the markets insatiable thirst for yield, Exhibit 5 shows that while the PEG Ratio of the High Growers increased modestly, the PEG Ratio of the Low Growers doubled during the QE era.

Exhibit 5
QE Era Propels Investors Into Low Growth

	High Growers	Low Growers
Dividend Yield	0.5%	2.1%
Hist 3Yr Sales Growth	19.2	3.7
Hist 3Yr EPS Growth	31.0	8.2
Est 3-5Yr EPS Growth	24.7	6.5
PEG Ratio	1.4x	3.4x



Source: FactSet as of 6/30/2017.

This set the stage, in our opinion, for the tremendous performance we have experienced in the first half of 2017. As fundamentals and price reconnected, Growth equities have outperformed and Winslow Capital has returned to strong alpha generation.

The Winslow Way

As investors, we believe Growth equities are a structurally advantaged asset class. Unlike their Value counterparts, Growth equities are not dependent on P/E multiple expansion to generate returns. As an example: the TTM P/E of the S&P 500 in October 2007, at the previous market high, was essentially identical to where it stood at the end of the first quarter of this year. During that period, while returns for the Large Cap Value Index increased 66%, the Large Cap Growth Index increased 110%, an almost two-fold higher return. This is a great example of the compounding effect of superior growth over time and the returns that can be achieved in a flat multiple environment, an important consideration given current market valuation levels. Additionally, many companies in our universe also generate free cash flow capable of financing their own growth, another valuable attribute, especially as interest rates may likely trend higher.

At Winslow Capital, we invest in quality growth companies with above average earnings growth. Our process focuses on Industry leaders and market share gainers in a growing marketplace, companies with strong and sustainable competitive advantages, proven management teams that can exploit those advantages and enhance shareholder return, companies that demonstrate sound corporate governance and finally, companies that have the highest probability of exceeding street consensus estimates and are attractively valued relative to our earnings and FCF growth estimates.

Instead of simply collecting a portfolio of the fastest growers, we uniquely diversify our portfolio across three distinct types of growth companies: Long-term Sustainable Growth, Quality Cyclical Growth and Newer/Faster Growth. Our portfolio is diversified across all three types of companies, typically with 25-40% in each category; thus protecting the portfolio from ever developing what we call a "Preferred Habitat". In addition to diversifying across the Three Types of Growth, our portfolio construction process further diversifies the portfolio by Sector, Industry, Earnings Growth Rate, Valuation and Capitalization.

Diversification, Flexibility and Consistency, these are the hallmarks of our process and the drivers of our success.

Summary

In summary, we believe we have now exited the QE-Era and are entering a new equity market regime. With bond proxy and P/E expansion headwinds behind us, we conclude the market will be more fundamentally driven and ideal for active equity management. Our 18-plus year track record demonstrates long-term outperformance and our seasoned investment team remains deeply convicted in the disciplines of our investment process. ■

Glossary

- EBITDA - A company's earnings before interest, taxes, depreciation and amortization (EBITDA). An approximate measure of a company's operating cash flow based on data from the company's income statement.

- Russell 1000® Growth Index - measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

- Basis Point - One one-hundredth of one percentage point, or 0.01%. For example, 25 basis points equals 0.25%.

- PEG Ratio - The PEG ratio (price/earnings to growth ratio) is a valuation metric for determining the relative trade-off between the price of a stock, the earnings generated per share (EPS), and the company's expected growth. In general, the P/E ratio is higher for a company with a higher growth rate.

- TTM P/E – Price to earnings ratio for twelve-month period, or trailing twelve months (TTM)

- FCF growth estimates – Free cash flow (FCF) is a measure of a company's financial performance, calculated as operating cash flow minus capital expenditures.

- Alpha - A measure of performance on a risk-adjusted basis.

Important Disclosures