Q1 2018
Thought Leadership

Investing In An Expensive World

Justin Kelly, CFA
CEO/CIO, Portfolio Manager

Stephanie Simon, CFA
Portfolio Manager

"Nothing is more expensive than a missed opportunity."
-H. Jackson Brown, Jr.

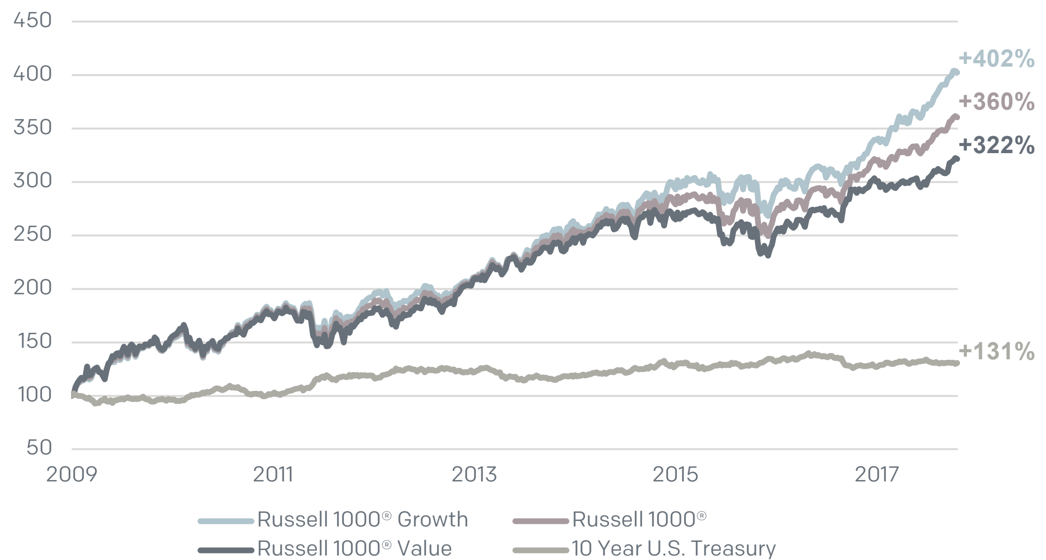
Executive Summary

Rich valuations for global financial assets will require investors to be much more selective in the coming environment than was needed in the first several years post the Great Recession. In addition, the level of disruption affecting many industries in the economy will likely reduce the efficacy of passively investing in these industries and sectors. The combination of higher valuations and increased industry-level disruption points to the need for deep fundamental analysis, insightful valuation and highly judicious security selection. Our work concludes that a new equity regime commenced in 2017 and finding companies that can compound earnings and cash flow growth at above-average levels will be the key to stronger absolute and relative returns in this regime. We view this environment as presenting the most compelling opportunity for active growth investing in more than a decade.

Valuations

As we approach the ninth anniversary of the equity market lows of March 2009, it is important to reflect upon how far the markets have come from those grim days. While it took fortitude to remain invested, March of 2009 presented an exceptional opportunity. Not panicking in the crisis and just staying invested in passive vehicles was often sufficient for investors.

Exhibit 1
Cumulative Returns Since Market Low (March 2009)



Source: FactSet weekly cumulative returns from 3/13/2009 to 12/31/2017. Past performance is no guarantee of future results.

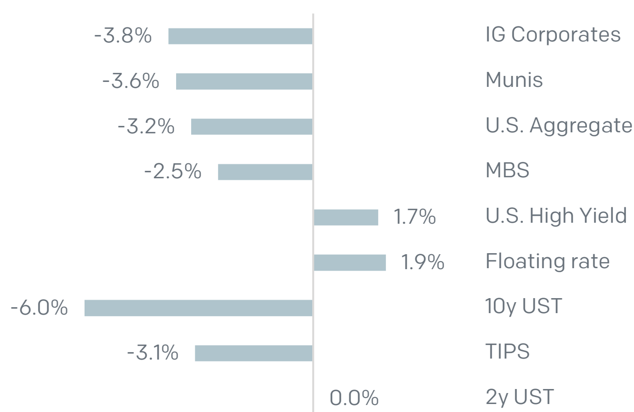
Given these exceptional returns, the key question for investors is where are the prospective opportunities now? In a previous paper, we noted valuations for bonds became excessive in 2016 when interest rates fell to their lowest levels globally in perhaps five millennia. These low global yields point to poor return expectations for

415852-INV-A-2/19

NOT FDIC INSURED NO BANK GUARANTEE MAY LOSE VALUE

fixed income securities. As indicated by Exhibit 2, just a 1% increase in yields can cause havoc in the asset class.

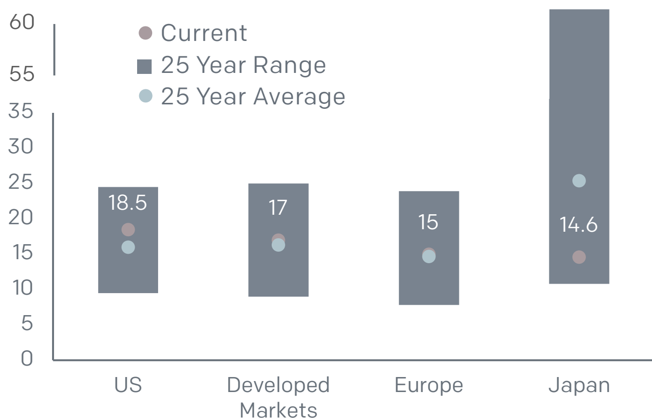
Exhibit 2
Impact of a 1% rise in interest rates on total returns



Source: JP Morgan Guide to the Markets as of 12/31/2017. Please refer to the last page for additional detail.[1]

Equity valuations, while not nearly as gilded, are reasonably full. On a P/E basis, most global equity valuations are ahead of longer-term averages.

Exhibit 3
Global Valuations



Source: JP Morgan Guide to the Markets as of 12/31/2017. Please refer to the last page for additional detail.[2]

In the U.S., the higher valuations are, in part, supported by the evolving composition of the S&P 500® which now has nearly 70% of its value in sectors that provide growth, relative stability and income, versus about 55% in 1990. As a result, U.S. equity indices have a lower beta and less cyclical exposure than most developed markets, which means higher valuations are more warranted. In addition, driven by the Information Technology sector's profitability and corporate tax reform, net profit margins for the S&P 500® are approaching 10.5%, also above long-term averages. In addition, while on the surface U.S. equities look more expensive than other markets, the composition of indices' and projected growth play a huge role.

Thus, while equity valuations have some support, the probability of meaningful P/E multiple expansion from these levels is low. This is in stark contrast to the post-2009 through 2016 equity regime with the S&P 500® P/E multiples expanding from 10x to 17x, for example. The key for future absolute and relative returns will be the ability to grow earnings and cash flow at levels ahead of the overall market; advantaging growth equities as an asset class. Given that growth equities have been the total return leaders since 2009, continued leadership may seem improbable to some. Yet the key differential is the compounding of earnings growth.

For example, if we assume P/E multiples return to their averages over the next five years, a growth stock with 13.4% earnings growth and a .8% yield would in theory generate almost three times the total return of an S&P-like stock with 6% earnings growth and a 2.0% yield.

Said another way, a high growth company can more readily afford multiple compression.

Finding High Growth Companies

The question then becomes finding those companies that can compound earnings growth at compelling levels. Fundamental expertise will be required. Over the 10 years ended in the Fall of 2017, the Winslow Capital Large Cap Growth portfolio generated 13.4% realized earnings growth on average per annum. Exhibit 4 demonstrates how difficult it is to find companies that can sustain high earnings growth.

Exhibit 4
Companies with > 13.4% EPS CAGR

EPS Growth	# of Stocks	% of Total
3yr CAGR > 13.4%	279	28%
5yr CAGR > 13.4%	253	26%
10yr CAGR > 13.4%	125	13%

Source: Winslow Capital internal estimates as of 12/31/17. Please refer to the last page for additional detail.[3]

Over the last 10 years, only about one in ten large cap growth companies has achieved more than 13.4% earnings growth on a sustained basis. Given the relative scarcity of big growers, we anticipate a narrowing of the market. This narrowing was evident in the first half of 2017, but was masked when the market broadened in anticipation of U.S. corporate tax reform. After a one time adjustment for tax reform, our work points to a narrow market going forward. The harsh reality of investing in an expensive equity market is investors will be required to be much more selective to achieve robust returns. The stocks of most large cap companies are poised for subpar performance in this new equity regime.

Major Disruption Is Occurring

Exacerbating the challenge of finding companies with strong earnings growth is the level of disruption in many industries. Disruptive technologies have been meaningful challenges to existing businesses since the dawn of the Industrial Revolution. However, over the last 200 years, there have been periodic waves of accelerated innovation often resulting in certain industries achieving astounding levels of growth.

The advent of automobiles, computers, PCs and the internet resulted in rapid disruption when introduced. The airline industry in the 1920s is illustrative. From almost nothing, in four years France built up an aircraft industry that employed nearly 200,000 people and produced some 70,000 planes; representing quite an advance given that only a few years earlier the entire aviation industry consisted of two brothers in an Ohio bicycle shop.

The current environment is reflective of another sea change; mobile technologies, cloud computing and big data usage are upending several sectors of the economy and the winners and losers are changing rapidly. So much so, that even well run and innovative businesses face upheaval and declining profitability. Companies in Retailing, Media, Consumer Brands, Telecommunications, Energy and even Real Estate face meaningful turmoil.

The challenges to retailers are becoming increasingly acute. In the past, retailers had to face new store concepts and evolving consumer preferences. Teens were and are often the most fickle consumers. Shifting teen taste went from Adidas in the 80s to Abercrombie in the 90s and then Nike in the 2000s and back to Adidas this year. Astute investors have long had to factor the vagaries of consumer taste of any age into projections and valuations. Now the shift to online purchasing has upended the old models and new more thoughtful analysis will be required. Amazon currently garners 40% of all incremental retail sales in the United States.

Tax reform was exceptionally positive to U.S. retailers as many had high cash tax rates. However, a question for investors will be how much of the reduced tax rates will be competed away through aggressive pricing tactics. The secular challenges to the industry will not change, despite the new tax rates.

Mobile usage has also reduced pricing power for retailers. Price discovery is instantaneous for many products. Honey, a software startup, may present a further challenge. The company's shopping assistant will automatically scour the internet for the best coupon available for any e-commerce transaction. Estimated savings totaled more than $170 million for consumers in 2017. The consumer is increasingly in control and all retailers will have to adapt further.

A recently published report noted that most consumers use their smartphones to research products while in a physical store. While millennials were the age group most likely to use smartphones for in store searches, and in fact did so nearly three-fourths of the time, baby boomers also pursued information nearly half the time they were in store shopping. Price comparisons were the largest reason shoppers used their phones on premise, but online reviews were also important.

Media also faces turbulence with linear television viewing rapidly shifting to on-demand. Netflix has been the notable winner thus far, but there is so much at stake for Disney, Comcast, AT&T and many others that complacency could be disastrous. Investing in media stocks will require ongoing deep analysis.

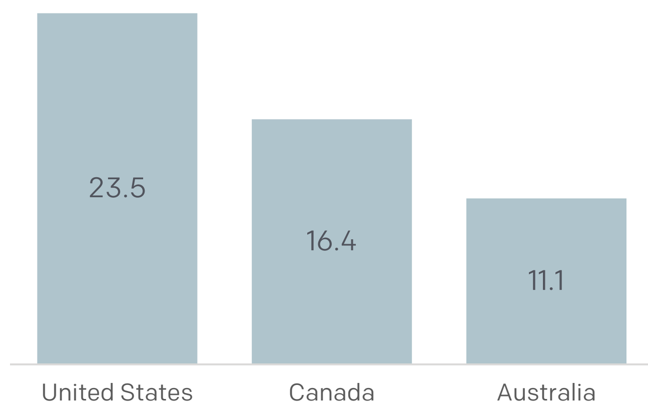
The evolution of consumer tastes has resulted in dramatic shifts in many consumer brands. The Consumer Staples sector was often a relative safe haven. The stocks in the sector exhibited dampened economic sensitivity. In addition, the biggest brand names were able to spend more than upstarts, thereby protecting their competitive moats. However, first tobacco, then soft drinks, then snack foods all faced greater pressure from an increasingly health-conscious consumer. Now mobile usage and peer reviews are further upending the Staples sector. While it is an exaggeration that brands are dead, they are clearly less valuable, diminishing the companies' projected terminal values. The once fortress-like businesses of Procter & Gamble, General Mills and Unilever are finding themselves buffeted on many fronts. Activist investors note declining revenues and are demanding expense reductions, while shifting consumer tastes require increased spending to drive innovation.

Another sector previously known for its relative safety was Telecommunications. Clearly, the industry should be a net beneficiary of increased mobile demand for data. Smartphones are nearly ubiquitous. Yet this level of ubiquity points to muted subscriber growth and increased pricing pressure on the service providers. As recently as 2015, a typical AT&T mobile plan was $70 per month and included 2 gigabits of usage with each additional gigabit priced at $15. In late 2017, a similar plan is now $90 but includes unlimited data and HBO for free. This has been costly for service providers when just 2 hours of streaming non HD video can use 1 gigabit.

The influence of technology is massively disrupting the Energy sector with geopolitical and equity market implications. U.S. crude production diminished steadily from 1969 through 2008. This all changed in 2009, when producers leveraged big data to pursue horizontal drilling and the fracking of shale. Correspondingly, WTI oil prices have declined from more than $145 per barrel in the summer of 2008 to around $60 at year-end 2017. Over the medium-term, oil prices will face the additional pressure from reduced demand associated with electric vehicles. Approximately two-thirds of oil usage is for fuel. The underlying technology associated with the internal combustion engine has been largely unchanged over the last 80 years, while Moore's Law is just starting to have implications for electric vehicles.

Finally, the era of extremely low interest rates also brought potential imbalances to industries that benefited from these levels. Commercial real estate may see challenges in the new regime. Cap rates, or the ratio of a property's net operating income to market value, are highly sensitive to interest rate movements and the magnitude of rising rates may dampen valuations in the Real Estate sector. This will be particularly challenging for the already burdened mall-based U.S. REITs as there have been waves of store closures in recent months. As shown in Exhibit 5, compared to our peers, retail space per person may face further reductions.

Exhibit 5
Square feet of retail space per person



Source: Business Insider as of 10/31/2016.

Conclusion
Fueled by stronger global economic growth and U.S. corporate tax reform, global equity markets were exceptionally strong in 2017 with the S&P 500® and the Russell 1000® Growth Index returning 22% and 30%, respectively. This continuation of positive performance from the equity market lows of 2009 masks an enormous sea change in the drivers of equity returns. The equity regime that ruled from 2009 through 2016 was characterized by Quantitative Easing, exceptionally low interest rates and P/E multiple expansion. The market essentially lifted all boats and passive investing was largely sufficient. A new equity regime commenced in 2017 and post the one-time adjustment of corporate tax reform, we anticipate a narrow market, that is, a select few stocks will drive a disproportionate percentage of equity return.

High valuations and high levels of company disruption will be the key elements of the current equity regime. The ability to look out over the horizon, deeply understand industry trends and how individual companies can perform within these trends, will be required. The macro-focused, risk-on/risk-off markets of the 2009-2016 equity regime have now given way to fundamentally-focused markets. Higher earnings and cash flow growth than those generated by most of the companies in the indices will be the key differentiator to returns going forward. Selectivity will be paramount to alpha generation in coming years. The crescendo of critics against active managers may be at a cycle peak. ■

Glossary

- Alpha - a measure of performance on a risk-adjusted basis
- CAGR - compound annual growth rate
- Multiple Compression - the effect that arises when a stock trades at a certain multiple and, while earnings may be strong, the stock price doesn't move up (or even goes down).
- P/E – price to earnings ratio
- Russell 1000® Growth Index - measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.
- Russell 1000® Index - measures the performance of the large-cap segment of the U.S. equity universe which includes approximately 1,000 of the largest securities based on a contribution of their market cap and current index measurement.
- Russell 1000® Value Index - measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.
- S&P 500® - unmanaged index generally considered representative of the U.S. stock market.

Important Disclosures

1 Assumes a parallel shift in the yield curve and steady spreads. Sectors shown above are provided by Barclays and are represented by – Broad Market: U.S. Aggregate; MBS: U.S. Aggregate Securitized - MBS; Corporate: U.S. Corporates; Municipals: Muni Bond 10-year; High Yield: Corporate High Yield; TIPS: Treasury Inflation Protection Securities (TIPS). Floating Rate: FRN (BBB). Yield and return information based on bellwethers for Treasury securities. Change in bond price is calculated using both duration and convexity according to the following formula: New Price = (Price + (Price * -Duration * Change in Interest Rates))+(0.5 * Price * Convexity * (Change in Interest Rates)^2).

2 Valuations refer to NTMA P/E. Valuations use MSCI indices for all regions/countries, except for the U.S., which is the S&P 500. All indices use IBES aggregate earnings estimates. MSCI Europe includes the Eurozone as well as countries not in the currency bloc, such as the U.K., Switzerland, Sweden and Norway (which collectively make up 49% of the overall index).

3 The universe represented includes 979 total consituents with market capitalizations greater than or equal to $3 billion within the S&P 500®, Russell 1000® Growth, Russell 1000® Value, Russell 2000® Growth and the Russell 3000®.

This material is not intended to be a recommendation or investment advice, does not constitute a solicitation to buy or sell securities, and is not provided in a fiduciary capacity. The information provided does not take into account the specific objectives or circumstances of any particular investor, or suggest any specific course of action. Investment decisions should be made based on an investor's objectives and circumstances and in consultation with his or her advisors. The views and opinions expressed herein are those of Winslow Capital as of 12/31/2017. The information presented herein is provided solely for informational purposes only. References to specific company stocks should not be construed as recommendations or investment advice. Winslow Capital does not make any representation or warranty, express or implied, as to the information's accuracy or completeness, nor is it recommended that this information serve as the basis of any investment decision. These views are subject to change without notice.

It should not be assumed that the securities discussed represent a Winslow Capital holding within its portfolios or that the securities discussed were profitable or that investment decisions made by Winslow Capital in the future will be profitable.

Past performance is no guarantee of future results. Equity investments are subject to market risk or the risk that stocks will decline in response to such factors as adverse company news or industry developments or a general economic decline. All investments carry a certain degree of risk, including possible loss of principal, and there is no assurance that an investment will provide positive performance over any period of time. Growth style investing may fall out of favor and underperform other equity investments during given periods. Certain sectors or growth stocks may shift characteristics over a long market cycle and may not perform in line with stated benchmarks. Different indices and economic periods will produce different results. Indices are unmanaged and unavailable for direct investment.

Winslow Capital Management is a registered investment advisor and an affiliate of Nuveen, LLC.