Thought Leadership:

A Fundamental Resurgence for U.S. Large Cap Growth Equities

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Executive Summary

Volatility in global markets is a reminder that the return opportunities in equities are generated over a market cycle (five to seven years). Throughout a market cycle, evolving views on macroeconomics and microeconomics will impact equity valuations. Headlines designed to grab attention rather than provide information may cause stocks to trade on sentiment rather than fundamentals for a short duration. However, as financial assets are only worth their cash generating abilities discounted over time, fundamentals ultimately drive returns.

It is therefore important that investors take a step back from short-term news and assess the arc of longer-term trends. Our research strongly suggests that these trends point to a compelling opportunity for equity investing in the U.S. on an absolute basis.[1] In addition, U.S. equities look attractive relative to many major asset classes. In this paper, we will detail the structural advantages of the U.S. economy and its stock market. We will highlight the advantages for active equity management over the next several years. There will certainly be negative headlines and worries over the current market cycle, but we expect that when this cycle has concluded, U.S stocks will have posted strong performance. We appreciate that this may sound hyperbolic given that as of December 31, 2015, the S&P 500 returned 12.6% per annum over the last five years.[2] However, we predict a continuation of compelling opportunities for U.S. equities. We also anticipate the resumption of active equity management outperformance.

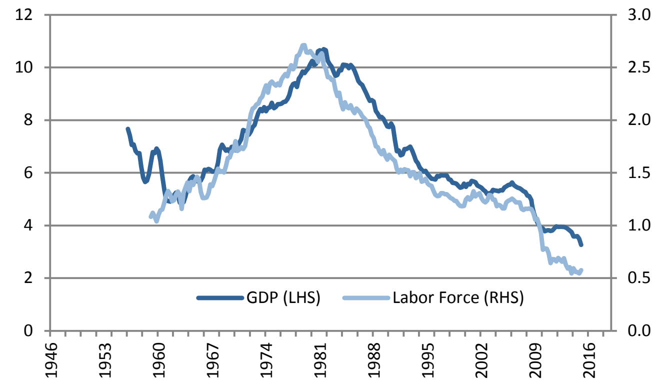
The Case for U.S. Equities

The correlation between growth in GDP and growth in the labor force is high, as is noted in Exhibit 1. The Working Age population will continue to grow through 2050 in the U.S. while it is already declining in the Eurozone (Exhibit 2). Perhaps surprisingly, this is also true for China. The working age population peaked for China in 2014 and now is anticipated to decline through 2050.[3]

1 Charles Schwab, "Q and A: Estimating Long-Term Market Returns" by Michael Lind. April 24, 2015.
2 Factset Research Systems, December 31, 2015.
3 ISI Group.

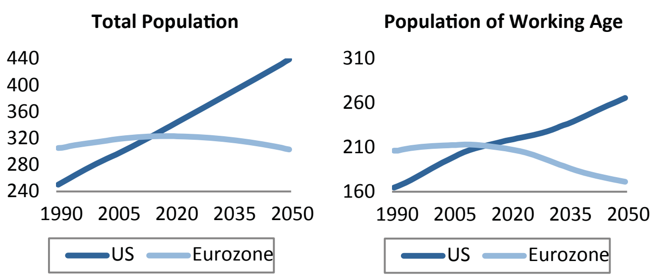
Exhibit 1: U.S. Smoothed Growth in Nominal GDP and Labor Force

Annual Rate of Change from same quarter 10 years ago



Source: ISI Group; BEA; BLS; Hokensen & Company. Annual rate of change from same quarter 10 years ago.

Exhibit 2: U.S. Population vs. Eurozone



Source: ISI Group; US. Census Bureau

In addition to being poised for GDP Growth, the U.S. economy is structurally prepared for that growth. The World Bank recently published a report on the ease of doing business that cited the U.S. as the 7th best out of 189 countries.[4] In developing its ranking, The World Bank considered such metrics as efficiency in capital raising, fixed asset investment, electrical grid connection and strength of legal framework. It noted that on most of the metrics assessed the U.S. was not only highly ranked but was improving in these metrics. Major economies such as Germany (#14), Japan (#29) and China (#90) all trailed the United States.[5]

Even with the structural advantages of the U.S. economy versus the majority of developed and developing market economies, the potential Federal Reserve rate increases have weighed on U.S. market sentiment. However, historically recessions commence on average four and a half years after the first Fed Fund rate hike, leaving ample economic runway for equity investing. [6]

Since 1929, recessions have always been preceded by either substantial central bank tightening or inflation acceleration, or both.[7] The expansion of the U.S. economy post the Great Recession has been well below historical growth rates.[8] The lower growth has facilitated exceptionally low interest rates and also may indicate that the duration of the currently expanding economy will be longer than previous cycles. With operating margins for large cap companies already at peak levels, slow global growth may lead secular growth companies to achieve materially higher earnings growth than cyclically focused companies. Cyclical companies are more dependent on macroeconomics and/or margin expansion for earnings growth.

In addition, there is a great deal of innovation occurring in the U.S. market. Driven by the plummeting cost of computing and the impact of mobile internet usage, another age of disruptive companies are being formed in the consumer services, software and healthcare industries. As of July 2015, our research identified more than 85 recently formed companies with implied valuations of $1 billion or more.[9] These “unicorns” typically differ from the immature — and in some cases fraught —business models of the dot-com era. Some have well-developed businesses and site lines to material cash flows. Investors can expect several of these companies to become investible in the public markets over the next several years. These businesses are frequently scalable on a global basis, but based in the United States.

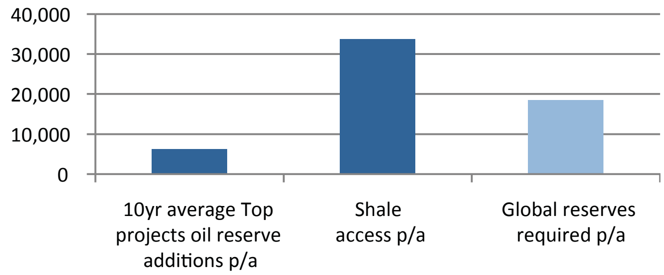
The biggest Chinese internet companies are largely copies of existing U.S. business models: Baidu is similar to Google, Alibaba to Amazon, Ctrip.com to Priceline. Each of these has chosen to list their securities on the U.S. markets rather than in Hong Kong, Japan or Europe.

Another prominent display of innovation has occurred in the sourcing of oil and natural gas. Plunging oil and natural gas prices are one byproduct of the impact of fracking technology that has developed over the last decade in the United States. Oil supply materially exceeds demand currently, with average oil reserves added at a level five-fold higher than global reserve requirements in 2015 (Exhibit 3).

4 World Bank, “Doing Business 2015” October 2014.
5 Ibid.

6 Cornerstone Macro
7 Weekly Economic Report, Evercore ISI, “Slower Longer, Lower Longer, Easier Longer” August 17, 2015.
8 Ibid.
9 WSJ Billion Dollar Start Up Club, updated as of July 9, 2015. Pitchbook, Capital IQ, Morgan Stanley Internal.

Exhibit 3: Average Oil Reserves Added vs. Global Reserve Requirement

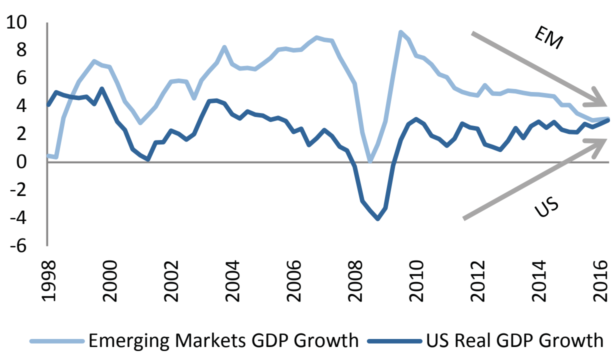


Source: Goldman Sachs Global Investment Research

Similar trends are evidenced in other commodity markets. Emerging market countries dependent on commodity exports, such as Brazil and Russia, are seeing their economies challenged. The contagion of the slowing growth in China means that for the first time in 15 years, U.S. economic growth rates and emerging market growth rates may converge (Exhibit 4).

These phenomena may not be fully understood by the market. A recent survey found that 40% of today's investors started their careers in or after 2000.[10] Thus, a large portion of current Wall Street members have only ever invested in a world where emerging markets dominate.

Exhibit 4: U.S. Growth On Trend to Overtake EM Growth

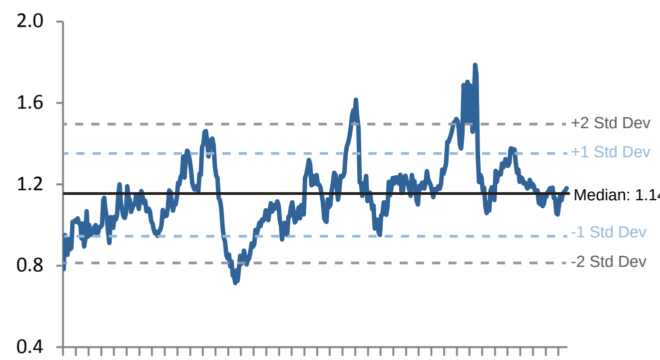


Source: Actual and forecasted numbers are provided by permission from Cornterstone Macro, based on Y/Y % GDP growth.

Valuations and Expected Returns

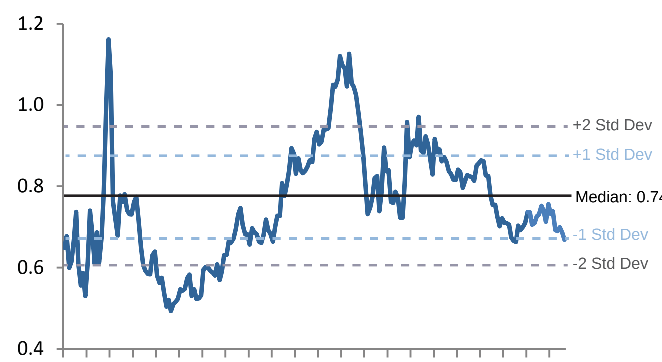
As of November 30, 2015 the S&P 500 was trading at 16.5x 12-month forward earnings,[11] a modest premium to the mean of 15x over that last 50 years.[12] Additionally, U.S. markets are also trading largely in line with historical averages relative to European equity markets. As well, emerging markets too are trading near median levels versus the developed world (Exhibit 5). With most price-to-earnings (P/E) multiples having been repaired from the Great Recession, multiple expansion is less probable in the coming years; we model that earnings growth will resume its predominance in driving equity returns.

Exhibit 5.1: Russell 1000® - P/E LTM Relative to MSCI Europe



Source: FactSet Research Systems. As of November 2015.

Exhibit 5.2: MSCI EM (Emerging Markets) - P/E Relative to MSCI The World Index



Source: FactSet Research Systems. As of November 2015.

10 Economics, Policy, Strategy & Technicals, Cornerstone Macro, "Does Age Ever Bring Wisdom on Wall Street?" by Francois Trahan, Michael Kantrowitz, CFA, and Emily Needeil, CFA. August 10, 2015.

11 Goldman Sachs Global Investment Research

12 McKinsey & Co., "Whither the US equity markets?" by Bing Cao, Bin Jiang, and Tim Koller. April 2013.

Long-term equity returns are linked to the performance of the real economy, including GDP growth, productivity, corporate profits, interest rates and inflation. From 1962 to 2012, real share prices grew 2.7% per annum, roughly the same rate as real profit growth and real GDP growth.[13] Real profit growth and equity returns tend to grow in tandem as P/E ratios tend to revert to the mean of 15x.[14] In fact, data show that the 15x P/E is consistent with average returns of equity of 13%, real cost of capital of about 7%, inflation of 2% and long-term profit growth of 2.5%.[15]

Over the last 50 years, investors have earned real share price appreciation of 2.7% and another 3% in dividends and share repurchases.[16] Payout levels have proven stable over the long term.[17] Company cash flows (profits less the portion reinvested to grow) will eventually contribute to shareholder returns.

Combining the two has resulted in about 6% real and 9% nominal returns for equities over the 50 years. A recent study by a leading investment consulting firm projects nominal returns for the three main asset classes: Global Equities of 7.9%, consistent with the long-term trends in U.S. equities; Global Fixed Income returns of 2.9%; and Real Asset returns of 5.6%.[18] Expected inflation for this period is 2.4%.[19]

Our research generally aligns with these expectations. We model 7% to 8% nominal returns for the U.S. in line with our expected earnings growth for the next five years. At best, we expect fixed income securities to generate single-digit returns should global interest rates rise from historically low levels. Real asset investments, such as timber and real estate, have historically provided diversification from equities. Some real assets are expected to generate returns in excess of bond returns, but these asset classes can be opaque, and the variability of managers' returns is very wide.

The Coming Challenge: Meeting Minimum Investor Return Thresholds

Many clients require returns approaching 7.5% for their investments. This return target is derived from spending requirements approximating 4.5% of the portfolio, projected inflation rates of 2% and a desire to grow the corpus modestly by about 1%. Table 6 highlights the challenge of achieving these goals given the expected returns.

13 Ibid.
14 Ibid.
15 McKinsey & Co., "Whither the US equity markets?" by Bing Cao, Bin Jiang, and Tim Koller. April 2013.
16 Ibid.
17 Ibid.
18 Consultant Study; Name withheld at Consultant request. September 2014.
19 Ibid.

Exhibit 6: Investor Return Analysis

Asset Class	Expected Return	Allocation Targets	
Global Equity	7.9%	60.0%	70.0%
Global Fixed income	2.9%	30.0%	15.0%
Real Assets	5.6%	10.0%	15.0%
Portfolio Expected Return		6.2%	6.8%
Shortfall per annum to typical 7.5% target		-1.30%	-0.70%

Source: Consultant Study; Name withheld at Consultant request. September 2014.

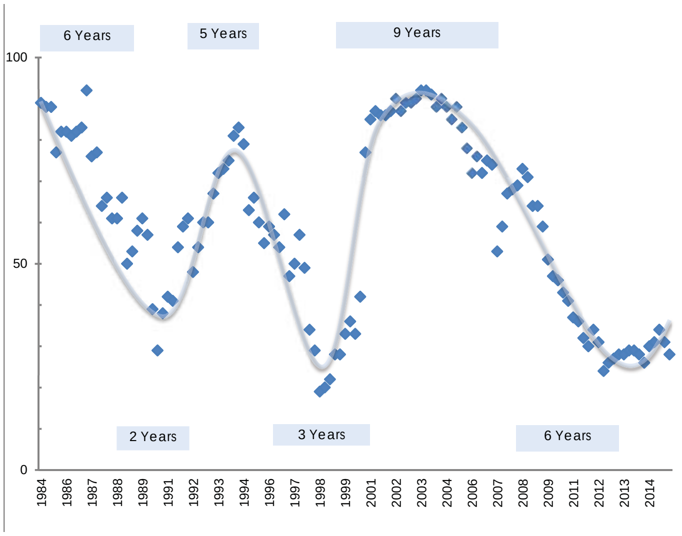
The truth investors must face is that simply investing in Index Funds for these asset classes is expected to result in a shortfall versus return requirements for many clients. Passive investing will be insufficient.

Cyclicality of Active Management

In a previous white paper, we detailed the cyclicality of active management.[20] In the paper, we examined rolling three year returns for U.S. Large Cap Growth active managers. Using this measure, active management has typically outperformed. In fact, there were only three periods since 1979 where more than 50% of large cap growth active managers failed to outperform the Russell 1000® Growth benchmark index for the three-year period.[21] All three of these periods were associated with a financial crisis. Although this data was already meaningful, we further argue that equity investing is subject to short-term variability, and three years should be the minimum timeframe to use in considering the impact of an active manager. Five years of performance data provides additional color, as is detailed on the next page (Exhibit 7).

20 http://www.nylinvestments.com/polos/MSLG38a-121451828.pdf
21 Ibid.

Exhibit 7: Rank of the Russell 1000® Growth Index Among Active Large Cap Growth Products using 5-year Rolling Returns



Source: eVestment, based on the eVestment US Large Cap Growth Equity Universe using 5-year rolling returns net of fees January 1, 1979 (inception date of the Russell Indices) to December 30, 2015.

As the chart highlights, many active managers outperform the Russell 1000® Growth Index on a long-term basis, even after assuming average institutional fees. Consistent with the three-year data, there are periods where active management has been challenged in aggregate, and these periods were again associated with financial crises.[22] The most recent period was the Great Recession. Then, P/E multiples for the S&P 500 Index expanded from 10.9x to 17.0x by year-end 2014.[23] This is an obvious headwind to active management as, in essence, all boats were lifted. Given that valuations are now in line with historic averages, the market is likely to become more discriminating, and in P/E multiple movements likely to be more muted. Fundamental stock pickers are now poised to outperform.

Equities are long-duration assets. Assessing a stock's performance over the short-term is not meaningful for long-term investors and often masks return opportunities. Consider Netflix over the past five years. It has been one of the best performing stocks in the S&P 500 over this period.[24] However, Netflix also had eight individual days of -10% returns.[25] Equities should be reviewed over a market cycle. Similarly, active equity management requires patience in order to see the real efficacy. Although monitoring a manager's performance on a monthly, quarterly or even annual basis is standard procedure, the information content in these data points is low. A more significant assessment during these interim periods involves style and philosophy drift, key personnel and asset class relevance. The review of active management from a performance standpoint should cover a full market cycle in order to begin to assess causality. Patience takes fortitude, but can deliver in the form of returns.

Muscle Memory and Bond Surrogates

Two other recent, and in our view transient, challenges to active management appear to be losing their influence. The muscle memory of volatile markets during the post-Great Recession risk on/risk off stock markets is abating. The largely macroeconomic events associated with concerns about European contagion, Russia's invasion of Crimea and the U.S. Fiscal Cliff that previously roiled the markets have been digested. Recent sell-offs — Spring 2014, Spring 2015 and August 2015 — associated with the timing and pace of scheduled tightening by the Federal Reserve have been shallower and shorter than previous bouts since 2009. We are led to conclude that the market is now more ready to reward or penalize stocks based on the company's idiosyncratic fundamentals rather than those of the market overall.

Another headwind that appears to be abating is the bond proxy phenomenon. Relatively high yielding utility and REITs stocks offer only modest earnings growth and thus fail to meet many Large Cap Growth investment thresholds. However, these stocks have been strong relative performers. With interest rates less likely to decline from current levels, the relative performance of these holdings may weaken.

Well Worth the Incremental Effort: Investing with a Top Quartile Active Manager

Unfortunately, many investors are trend followers and have been pulling money away from active management at an inopportune time. Retail and institutional investors have withdrawn $1.5 trillion from active products since 2008.[26]

Expected returns for the major asset classes as a whole are likely to underperform the required levels for many investors. Thus, active management should play a vital role in the effort to achieve the investor's requirement. Top-quartile active managers in the U.S. Large Cap Growth sector have generated in excess of 3% incremental returns per annum over the last 15 years (even inclusive of this most recent challenging period for active managers).[27] If expected equity index returns are 7.9%, a top quartile manager could add 3% to this number. This nearly 40% higher return would be sufficient to generate the results required by many investors (Exhibit 8).

22 See Exhibit 6
23 FactSet Research Systems forward earnings (10.9 at 9/30/11; 17.0 at 12/31/14).
24 FactSet Research Systems as of 11/30/2015.
25 Ibid.
26 FMMI Inc., "Active Share: Peeling Back the Onion, Retail Brokers' Existential Crisis" by Michael L. Goldstein and Beth Segers. June 2015.
27 eVestment U.S. LCG Equity Managers Universe 15-years ended 9/30/2015.

Exhibit 8: Investor Return Analysis, cont.

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Real Assets	5.6%	10.0%	15.0%
Portfolio Expected Return		6.2%	6.8%
Shortfall per annum to typical 7.5% target		-1.30%	-0.70%
Alpha for Active Equities	3.0%	60.0%	70.0%
Incremental total portfolio return		1.8%	2.1%
Portfolio Expected Return with alpha		8.0%	8.9%

Source: Winslow Capital; Consultant Study; Name withheld at Consultant request. September 2014.

Another benefit of active management is downside protection. Investing with active managers with high information ratios means that investors are receiving incremental returns with less volatility than the underlying benchmark over time.

Over the longer term many Large Cap Growth managers do outperform, flying in the face of conventional wisdom. The challenge for investors is to determine which managers ex- ante will outperform ex-poste. There are many good resources available for investors in this effort, including investment management consultants and financial advisors. Important areas to be assessed include the tenure of key investment manager personnel, the consistency of the investment processand the return potential and volatility of this process. In addition, we believe exceptional active managers have some key characteristics.

Domain expertise - In his seminal paper, Harry Markowitz helped develop Modern Portfolio Theory with key insights on risk and diversification.[28] One outcropping of this work was the development of style boxes by Morningstar. Style boxes provide key tools for classifying investments and allocating capital. They make a great deal of sense as investors pursue the Efficient Frontier from a risk/reward perspective. The perhaps unintended but very real benefit of style boxes is that they facilitated a profound level of expertise for certain committed managers. A multi-asset, unconstrained active manager is in many respects disadvantaged to a style-based active manager. The latter will have focused on a group of securities in their respective asset class facilitating deep knowledge of the securities fundamentals, markets, and managements.

Trading acumen – By definition, equity market volatility means that opportunities to invest in stocks at a discount occur frequently. To take advantage of these opportunities, an active manager needs the ability to quickly analyze the situation. This ability stems from deep pre-existing knowledge of the company and how it compares to those other opportunities competing for scarce capital. It also requires a highly skilled trading desk able to find liquidity in the market.

A study by Nobel Prize winner Vernon Smith indicated that when inexperienced traders were involved in simulated markets, these markets became more volatile. He concluded that experienced traders reduce boom bust market cycles.[29] Members of the Wall Street marketplace evolve continuously. As mentioned, 40% of current investors started their careers in 2000.[30]

Management Dialogs - Active managers with outstanding reputations have valued added dialogs with company managements. These active managers can help frame market perceptions of key financial metrics used to monitor the company. In a recent White Paper, we cited one important example, the power of Capital Allocation.[31] As Wall Street converges with the views of active managers, stock value can be uncovered.

Summary

The opportunity set afforded by U.S. equity investing looks compelling. A sustained era of active management outperformance would be consistent with historical trends, and appears likely. The 12.6% per-annum absolute returns over the last five years[32] are unlikely to be repeated but positive single-digit returns for the market over the market cycle seem probable. We are led to conclude that the incremental returns produced by top quartile active managers will be significantly higher than what the equity market can generate.

We are pleased that over the last 16 years, we at Winslow Capital have been able to generate 310 bps of alpha per annum, even inclusive of the challenged environment for active management since 2009.[33] The alpha generated for our clients over these years has been produced by a highly seasoned team of investment professionals who average 28 years in the industry. It is also the result of the consistent application of our disciplined investment process. We remain confident in the future U.S. Large Cap Growth equities on a relative and absolute basis.

28 "An In Depth Look at the Information Ratio" by Sharon L. Blatt. August 2004.

29 Smith, V./Suchanek, G./Williams, A. (1988): Bubbles, Crashes, and Endogenous Expectations in Experimental Spot Asset Markets, p. 1129.

30 Economics, Policy, Strategy & Technicals, Cornerstone Macro, "Does Age Ever Bring Wisdom on Wall Street?" by Francois Trahan, Michael Kantrowitz, CFA, and Emily Needeil, CFA. August 10, 2015.

31 http://www.nylinvestments.com/polos/MSLG38b-021552908.pdf

32 Factset Research Systems, December 31, 2015.

33 As of 12/31/2015. Performance results are gross of management fees. Past performance is no guarantee of future results. Index returns include reinvestment of income but do not reflect taxes, transaction costs, advisory fees or other expenses that would reduce the performance of an actual account.