U.S. Large Cap Growth Stocks

Asset class leadership for the 2020 decade

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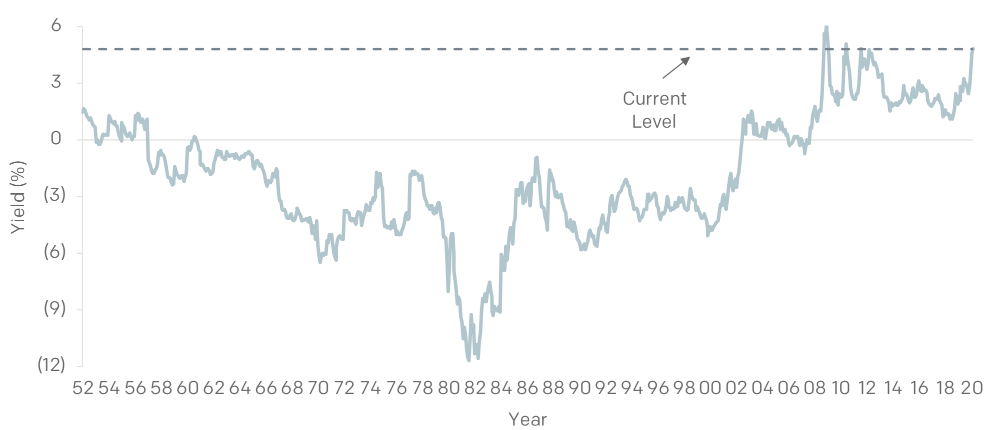
Justin Kelly, CFA
CIO/CEO
Portfolio Manager

Growth companies generating superior free cash flow margins are best positioned to deliver superior returns. And today, they are on sale.

The spread of COVID-19 has led to a sharp correction in U.S. large cap stocks, setting up a compelling opportunity to allocate capital to the likely asset class leader over the next decade — U.S. large cap growth. The valuation disparity between stocks and bonds is nearly unprecedented and the dividend yield on the S&P 500 is now twice the 10-year government bond yield. Even more revealing, the free cash flow yield of large cap stocks is at an all-time high relative to bonds (see Exhibit 1). From nearly every perspective, the starting point for stocks relative to bonds is substantially advantaged. While the economic shock from the COVID-19 pandemic will likely cause some disruption in the dividends of certain companies, in aggregate they will likely resume their growth as economic activity normalizes.

Exhibit 1

Free Cash Flow Yield of Large Cap Stocks less that of the 10-Year Treasury Bond
(1952 through March 2020)

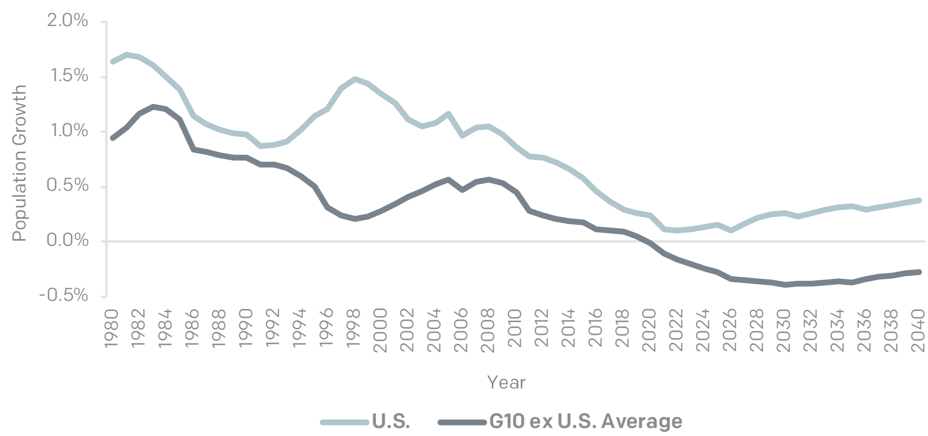


Source: Federal Reserve Board, Corporate Reports, National Bureau of Economic Research, Empirical Research Partners Analysis. Excludes financials, REITs and utilities; capitalization-weighted data Empirical. Data as of 3/31/2020 for the period 3/1/1952 (start of available data) to 3/31/2020.

U.S. large cap growth stocks have outperformed over the last decade within a world of slow global growth and substantial technological change. Global growth has been challenged in recent years by trade wars, policy uncertainty and demographics. While we believe the recovery from the pandemic will be strong, the decade ahead will likely experience the slowest global growth in modern times, driven by slowing demographics (see Exhibit 2). The U.S. demographic outlook is a bright spot relative to other developed countries. In addition, the U.S. has an impressive innovation advantage relative to other countries in this time of great technological change. If the U.S. does indeed produce the best economic growth, then the U.S. dollar may continue to strengthen, further challenging U.S. dollar returns of international stocks.

Exhibit 2

Growth of Working Age Population (20-64)



Source: United Nations, Department of Economic and Social Affairs, Population Division (2019). World Population Prospects 2019, Online Edition. Rev. 1. G10 is defined as Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. Data shown for the period 12/31/1980 (start of available data) to 12/31/2019. Data includes projected periods. Different assumptions could result in materially different results.

In a slow growth world, growth stocks have an advantage over value stocks because the growth differential is wider than historical averages. Many value sectors such as Energy, Financials, Materials and Industrials perform best when global growth is strong, such as in the decade of the 2000s when China was powering global growth. Further complicating the picture for value stocks is the massive technological change we are all experiencing in our daily lives. Large U.S. growth companies such as Amazon, Microsoft and Google are galvanizing these changes, whereas many value companies are being disrupted. The primary risk for these high-quality growth stocks has been the potential for valuation compression and the recent selloff has reduced this risk.

We believe the most underappreciated tailwind to U.S. large cap growth stocks is the substantial expansion of free cash flow margins over the last twenty years. The higher the free cash flow margin, the more capital is available to add to shareholder returns through strategic acquisitions, buybacks and dividends. This augmentation to growth is even more highly valued in a slow global growth world. Academic research supports free cash flow becoming a more important metric. In a January 31, 2020 paper by Katharine Adame, Jennifer Koski, Katie Lem and Sarah McVay from the University of Washington, "Why Are Investors Paying More Attention to Free Cash Flows?" the authors state, "Collectively, our results suggest free cash flow may be increasingly important for market participants going forward." The authors go on to say, "it may also be the case that free cash flow is more value-relevant for some types of firms, and over time the composition of firms in the market has shifted to more free cash flow-relevant firms." Tech-heavy U.S. large cap growth stocks are best suited for this environment.

Exhibit 3

Free Cash Flow Margins of Large Cap Stocks by Quintiles of Market Cap
(1953 through March 2020)

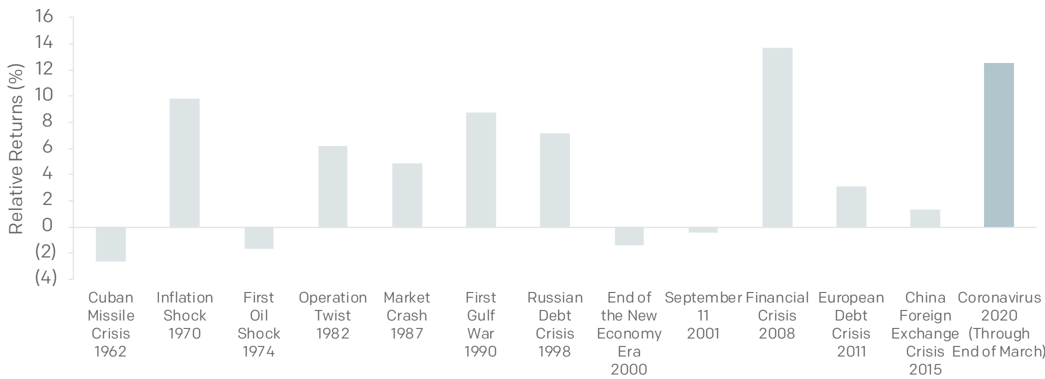
Source: National Bureau of Economic Research, Empirical Reserch Partners Analysis.Measured in aggregate; trailing four-quarter data smoothed on a trailing six-month basis. Data as of 3/31/2020 for the period 1/1/1953 (start of available data) to 3/31/2020.

It is also interesting to observe the expansion of free cash flow margins has not been consistent across the market cap spectrum. While there has been some modest improvement in small and mid-cap free cash flow margins, the vast majority of the expansion has come from the larger growth companies (see Exhibit 3). Larger companies are better positioned to leverage technology, global supply chains and other efficiencies propelling margin expansion.

The power of free cash flow margins in variable economic and market conditions is notable. Companies demonstrating superior free cash flow margin characteristics have historically outperformed in market downturns, including, to date, the recent COVID-19-induced correction, as can be seen in Exhibit 4. The outperformance of large cap growth stocks during the pandemic-driven selloff has surprised many people. We accord this outperformance to the substantial free cash flow protection and cash-rich balance sheets of the leading growth companies.

Exhibit 4

Relative Returns of Large Cap Stocks to the Highest Quintile of Free Cash Flow Margins from Peak-to-Trough in Market Sell-Offs (1962 through March 2020)

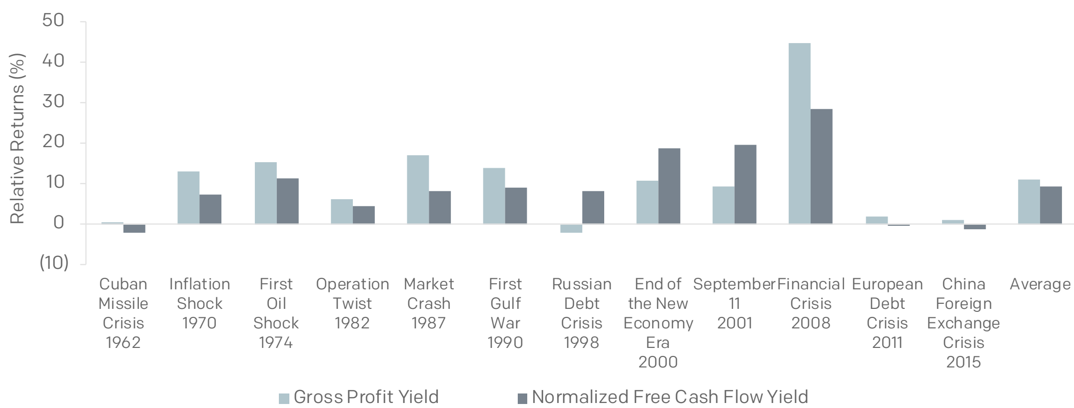


Source: Empirical Research Partners Analysis. Equally-weighted data, unannualized. Daily data compounded for the period of 1962 (start of available data) to 3/31/2020.

Importantly for investors, however, companies with superior free cash flow margins are also poised to perform well in subsequent market recoveries, as seen in Exhibit 5. This resilience is impressive, positioning portfolios well to protect capital in market declines, while also capturing opportunity with outperformance in subsequent recoveries.

Exhibit 5

Relative Returns of Large Cap Stocks of the Highest Quintile of Gross Profit Yield and Normalized Free Cash Flow Yield in the Year After the Market Bottom in Past Sell-Offs (1962 through March 2020)

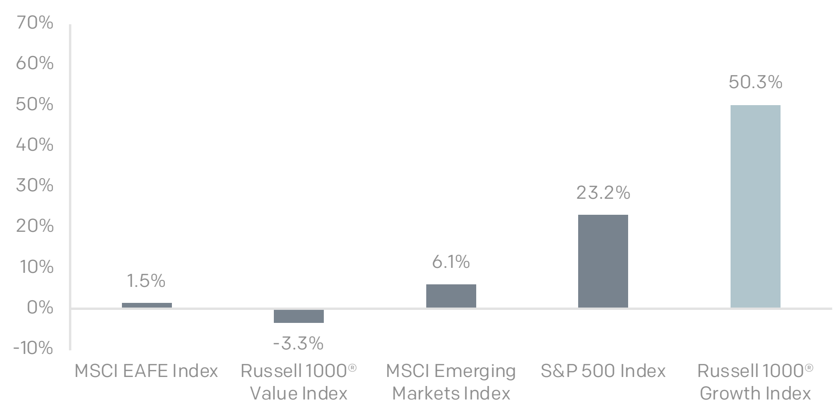


Source: Empirical Research Partners Analysis. Equally-weighted data; data shown for the period of 1962 (start of available data) through 3/31/2020.

Our research concludes U.S. large cap growth stocks began a period of sustained leadership starting in 2017 due to a meaningful growth and free cash flow premium compared to other equity styles. This can be seen in Exhibit 6 below, where the Russell 1000® Growth Index has outperformed other style and market indices. We believe the long-term benefits of this free cash flow profile are in the early days of recognition, especially when compared to longer-term risk-free rates.

Exhibit 6

Cumulative Returns (2017 through March 2020)



Source: Advent Portfolio Exchange. Cumulative returns for the 3.25 years ended 3/31/2020. The time period selected represents what is widely accepted as the end of the synchronized global quantitative easing that was initiated as a result of the Great Recession and the time at which we believe U.S. Large Cap Growth stocks began a period of sustained leadership among other asset classes.

We believe the most underappreciated tailwind to U.S. large cap growth stocks is the substantial expansion of free cash flow margins over the last twenty years. Companies with superior free cash flow margins have demonstrated extraordinary resilience, outperforming in both market downturns and subsequent recoveries. With the recent correction in valuations, an investment manager with a powerful and experienced research team constructing a portfolio of large growth companies with superior free cash flow characteristics is well-positioned to outperform.

[1]The harmonic average is used when averaging ratios that may produce extreme results due to small relative numbers in the denominator, such as P/E, P/B, etc. The harmonic average by itself does not exclude extreme values (positive or negative), it simply reduces the impact of extreme observations on the aggregate calculation. The harmonic average is calculated by dividing the number of observations by the reciprocal of each number in a series.

Performance results are gross of management fees. Percents may not sum to totals due to rounding. 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.

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