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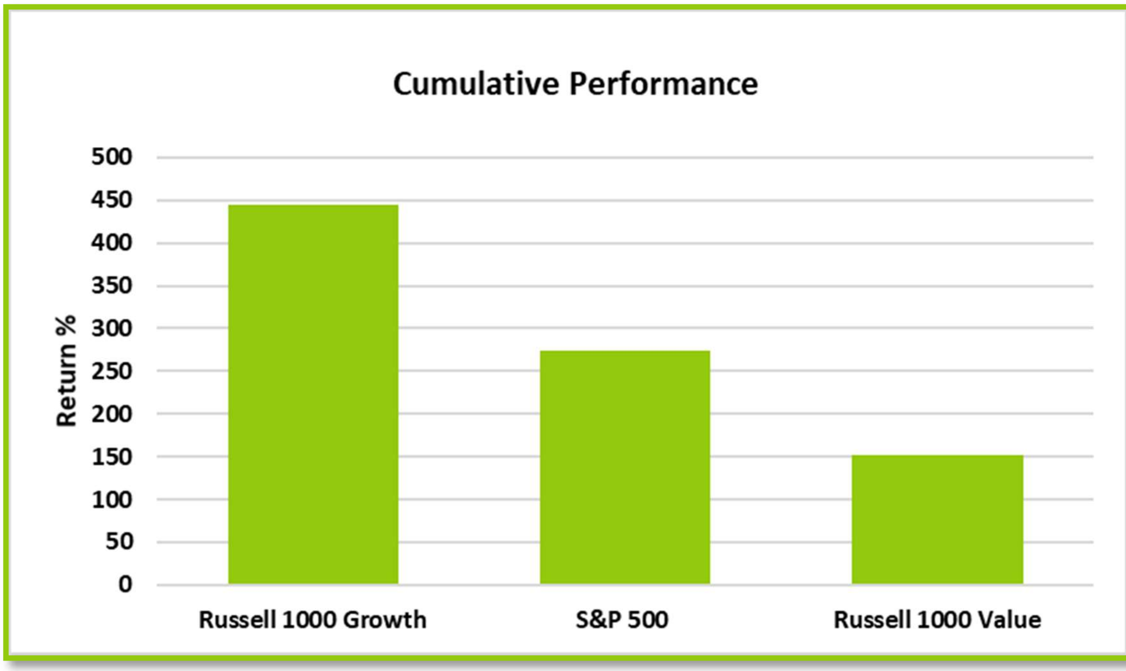
Thought Piece: U.S. Large Cap Growth
December 2020

For much of the last 15 years, growth stocks have managed to outpace the broader market and value-oriented companies. The Russell 1000 Growth Index (R1000G) has outperformed the overall market, represented by the S&P 500 Index (S&P 500), in 10 out of the last 15 calendar years. As of September 30, 2020, the R1000G outpaced the S&P 500 on a cumulative basis by over 150% over the previous 15 years. The gap has grown wider in recent years, given the strength and leadership of growth-oriented companies. The dispersion is even more pronounced when growth's results are compared to the value benchmark with the R1000G outpacing the Russell 1000 Value Index (R1000V) by nearly 290% cumulatively over the same time period.[1] Despite calls by experts that this wide performance discrepancy cannot persist, U.S. growth companies continue to be the preferred choice of investors, leading the growth benchmark higher.



Source: Investment Metrics - 15 Years as of September 30, 2020

Over the last few years, the R1000G has grown more concentrated than other U.S. Equity Indices. While investment managers in the category invest primarily in large companies with higher forecasted growth rates across numerous sectors, the Information Technology sector's weight dominates the index, accounting for nearly 45% of the index's market cap as of September 30, 2020. The Healthcare, Consumer Discretionary, and Communication Services sectors also each have weights of greater than 10%. Even though the index comprises approximately 447 securities, the largest five stocks by market cap (Apple, Amazon, Microsoft, Alphabet, and Facebook) represent over 35% of the index. For context on how the index has grown more idiosyncratic, the concentration in the top three companies has nearly tripled in the last five years. As of June 2015, the index's top three stocks accounted for roughly 10% of the total market capitalization compared to nearly 30% today. Lastly, the COVID-19 crisis has strengthened and expanded current trends, increasing momentum for technology-related stocks. For example, on August 18th, 2020, The Census Bureau of the Department of Commerce announced that the estimate of U.S. retail ecommerce sales for the second quarter of 2020 increased 31.8% from the first quarter of 2020.[2] Additionally, the demand for cloud-based video conferencing has surged as countries have imposed strict guidelines to arrest the pandemic and companies encouraged their workforce to work remotely.[3]

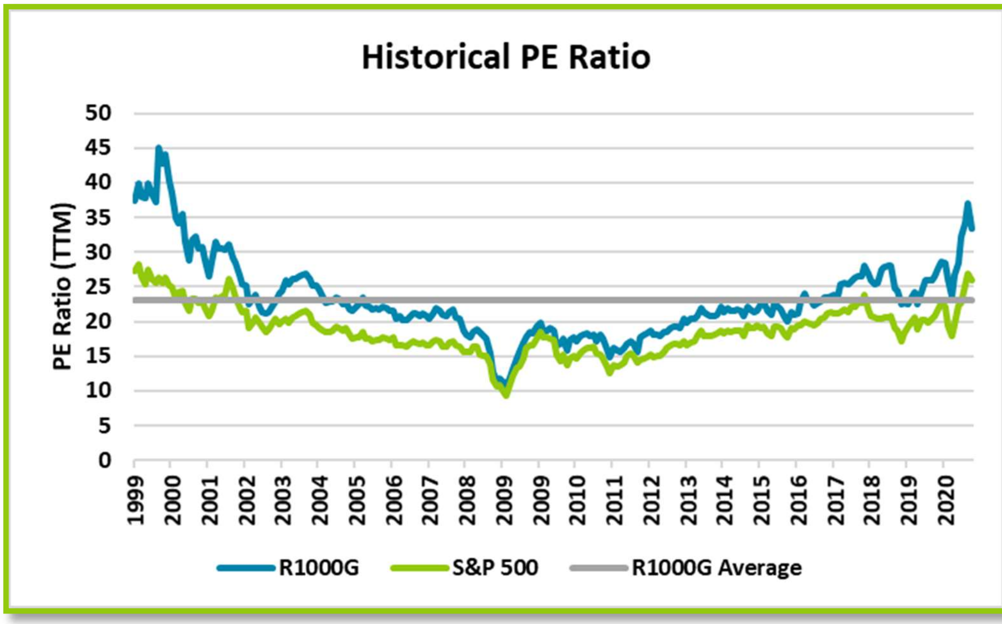
While growth indices may continue to move higher if this phenomenon continues into the near future, investors should be aware of the risks that high benchmark concentration can represent. As an example, we have witnessed growth managers relaxing their risk controls by increasing their maximum individual position limits to account for the fact that some of the heavily-weighted index names also represent high conviction ideas in client portfolios. Unfortunately, most investment managers employ risk limits that prevent them from structurally overweighting these securities in client portfolios. While we do not like to restrict managers by imposing counterproductive strategy constraints, allowing managers to relax their risk controls to increase individual position sizes above levels previously deemed prudent subjects client portfolios to increased idiosyncratic risk and potentially higher levels of portfolio volatility as a result of heavy concentration and larger position sizes.

Even though the U.S. equity market continues to be driven higher due to the leadership of a narrow group of stocks, we believe it is important to maintain diversification across multiple equity styles and asset classes. Despite the R1000G providing exposure to more than 400 securities, we believe investors in passive growth strategies should be cognizant of the fact that more than one-third of their allocation is invested in just five stocks. Importantly, while we are conscious of the top holdings' strength in the category, we do not envision these companies leading the market indefinitely. Additionally, as this group of technology-oriented companies continue to increase in size and influence, the legal and regulatory scrutiny around them has also increased, which may result in changes to their business models and/or litigation.[4] Although we do not know what will cause the growth of these companies to falter from their current trend, history illustrates that when a company's growth drivers are compromised, momentum and sentiment can reverse quickly. As shown on the table below, as of March 31, 2000, growth indices were outpacing value indices over the 1,5,10 and 15 annualized trailing year periods by a considerable margin. However, one year following the Dot-com bubble peak, as of March 31, 2001, growth indices trailed value indices for the 1,5,10 and 15 annualized trailing year periods.

Comparative Performance- As of March 31, 2000				
	1 YR	5 YR	10 YR	15 YR
Russell 1000 Growth	35.1%	31.8%	21.6%	19.8%
Russell 1000 Value	6.3%	21.0%	16.0%	16.3%
Difference	**28.8%**	**10.9%**	**5.6%**	**3.6%**
Comparative Performance - As of March 31, 2001				
	1 YR	5 YR	10 YR	15 YR
Russell 1000 Growth	-42.7%	11.6%	12.7%	12.9%
Russell 1000 Value	0.3%	14.2%	15.2%	13.9%
Difference	**-43.0%**	**-2.7%**	**-2.5%**	**-0.9%**

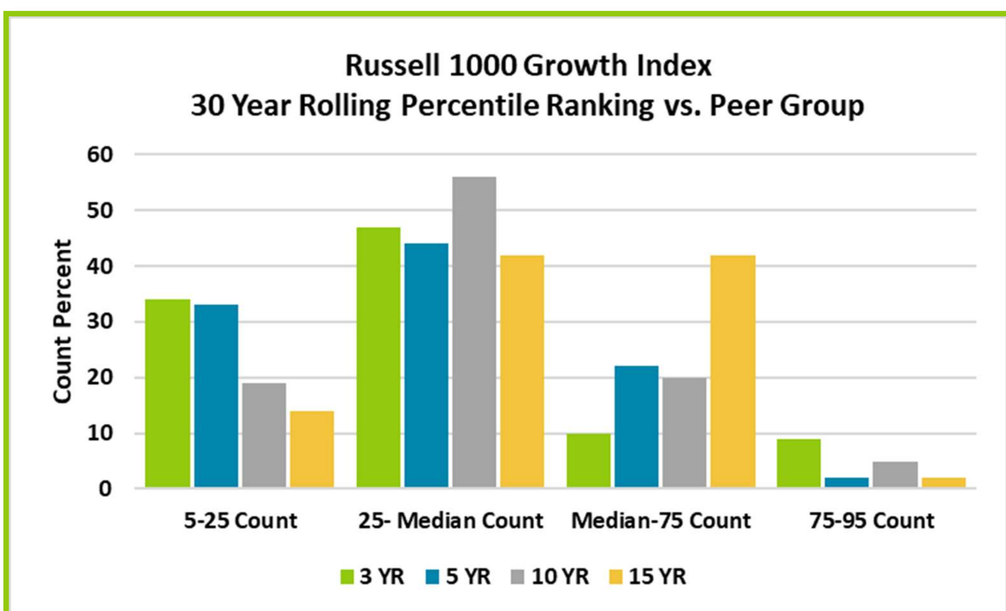
Source: Investment Metrics

As shown on the chart below, as of September 30, 2020, the R1000G is trading at a price/earnings (PE) ratio of approximately 33x, which is nearly 45% above its long-term historical average of roughly 23x. However, despite its elevated reading, it remains below levels it reached in late 1999 and early 2000.[5] Importantly, the current low interest rate environment is contributing to higher growth equity valuations as investors are willing to pay more for growth rates in excess of GDP growth and higher return expectations relative to other asset classes such as fixed income. Furthermore, as some of the category's largest companies have solid business models that may continue to benefit from secular tailwinds and broad structural trends worldwide, investors have been willing to purchase their stock shares despite their above average valuation levels. Examples of long-term growth trends that benefit companies in the category are cloud conversion, digital payments, health technology, and artificial intelligence.



Source: Morningstar as of September 30, 2020

In examining the R1000G's historical returns, although the index has performed above the growth peer group median 75% of the time when looking at rolling 3, 5, and 10 year-periods over the past 30 years as of September 30, 2020, the percentage decreases meaningfully when looking at a rolling 15 year timeframe as the index ranked above the median roughly 56%.[6] Notably, history has shown that active managers tend to outperform the index during down markets. As evidence, the R1000G ranked marginally below the Investment Metrics (IM) U.S. Large Cap Growth peer group median during the global financial crisis drawdown from October 31, 2007 to March 31, 2009.



Source: Investment Metrics as of September 30, 2020 – Peer Group IM. U.S. Large Cap Growth Equity

U.S. Large Cap Growth equity is typically a significant allocation for institutional portfolios. We continue to believe the asset class is an important strategic component of portfolios and provides diversification from value-oriented equity allocations. While we are cognizant of the performance and valuation dispersion between Large Cap Growth stocks with other areas of the equity market in the short- and mid-term periods, we are also aware of the secular tailwinds that growth-oriented companies have experienced over this period. Although value-oriented companies have historically outperformed coming out of recessionary periods, we also acknowledge that the COVID-19 crisis has accelerated current trends for growth-oriented companies compared to broader areas of the market. Finally, while we appreciate the diversification benefits of index strategies, we believe investors should recognize the potential risk when an index's concentration moves to extreme levels. There is still a lot of uncertainty in the market and we believe portfolios may benefit from active managers that can express stock-specific differentiation relative to the index by identifying companies that may come out stronger and recover faster.

Appendix

1. Investment Metrics as of September 30, 2020
2. https://www.census.gov/retail/mrts/www/data/pdf/ec_current.pdf
3. https://www.wsj.com/articles/zoom-again-lifts-full-year-outlook-as-sales-surge-during-pandemic-11598906550
4. https://www.bloomberg.com/opinion/articles/2020-08-03/apple-amazon-facebook-and-google-faithful-face-regulatory-risk
5. Morningstar as of September 30, 2020
6. Investment Metrics as of September 30, 2020