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Opportunities in US Growth

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In brief

US growth investors have experienced annualized returns of 8.2% in large-cap and 8.4% in mid-cap equities over the past 25 years, underscoring growth as a rewarding investment style.[1] This success has had different catalysts over the years, but one common thread is that earnings — not multiple expansion or dividends — drive stock prices over the long term. Despite the multiple transitory periods of volatility where macro or other factors dominated, a return decomposition demonstrates that earnings growth explains most of the long-term equity performance. It is our belief that fundamentals drive earnings and cash flow, which drive long-term stock price performance. We focus on identifying companies that can generate above average rate and duration of earnings growth over a market cycle. Our bottom-up fundamental research has led us to identify multiple high-level themes that have developed over the last five years. We believe we are in the early innings of important changes in the market that will have large implications across multiple sectors in our equity investment universe.

In this paper, we will discuss:

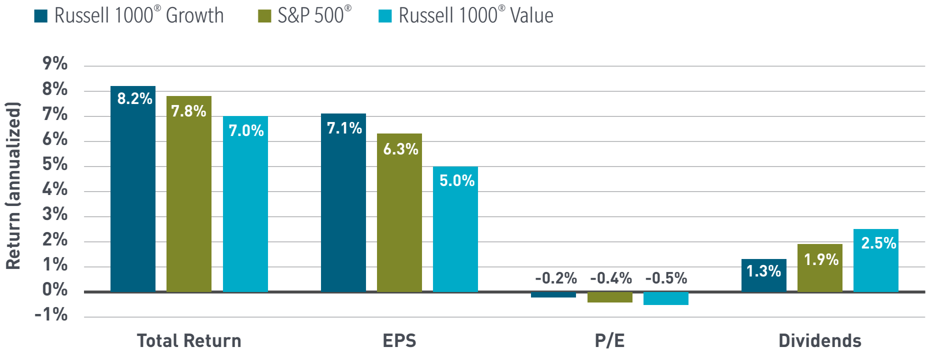
- Our approach to stock picking within a growth equity framework
- New opportunities and trends in the investment landscape
- The importance of investing through the cycle in companies with durable earnings

Our approach to growth

We are long-term, bottom-up fundamental investors. We believe fundamentals drive earnings and cash flow, which in turn drive stock prices.

See Exhibit 1 below for a long-term return decomposition of the Russell 1000® Growth Index, S&P 500® Index, and Russell 1000® Value Index. When you disaggregate the long-term return of US equities since 1999, the data show that earnings explain most overall stock price returns, despite multiple short-term, transitory periods where macro or other factors appear to dominate. Price-to-earnings (P/E) multiples expand and contract over time and explained less of the overall return while dividends accounted for a slightly larger share of the overall return.

Exhibit 1: US Equity Return Decomposition (1999–2024)



Source: FactSet Market Aggregates. Data as of: 31 May 1999 to 31 May 2024. Total returns (gross) are in US dollars and annualized for the timeframe. Earnings-per-share ("EPS") use mean broker estimates for next-twelve months. Forward price-to-earnings ("P/E") and EPS impacts calculated as the natural log of the division between the starting value and the ending value from the measured timeframe. Dividend impact is calculated as the difference between total return impact and price return impact. A percentage share of the overall cumulative return is attributed to each component to determine the annualized contribution.

We are long-term investors with the goal of generating consistent risk-adjusted returns for our clients. We identify high-quality companies that can generate above-average rate and duration of growth over the long term, with a focus on consistency of growth. Companies that can generate consistent above average growth often share some common characteristics, which we seek to identify through robust research. Some of these characteristics include:

1) Strong competitive advantage in a growing market

2) Unique product or service

3) High barriers to entry

4) Pricing power

5) Ability to expand margins

6) Support of a strong secular theme

The support of a strong global secular theme can be a key driver of long-duration revenue and earnings growth and can sometimes counteract macro headwinds when they arise. Our focus on the long-term drivers of company earnings magnitude and duration provides us with an opportunity to identify substantial shifts in market trends. This can help us to unlock value for investors by getting in front of big, secular changes in demand that benefit these companies. Today, we believe we are in the early innings of some very strong secular growth themes that will change the investment landscape across multiple sectors and create new business opportunities. These themes are set to benefit a spectrum of companies, from the builders of the in-demand products to those responsible for the infrastructure or materials that allow their use, all the way to the companies using these devices to improve themselves through operational advances. Below is a summary of where we are finding some of these exciting investment opportunities.

Where are the exciting opportunities in growth equities?

We believe there are both structural and cyclical tailwinds in place that can drive earnings across a broad range of industries during the next cycle. We see several markets expanding and new opportunities at a rate unlike anything we have seen over the past decade.

- **Artificial intelligence** – AI is evolving rapidly and is driving investment in multiple end markets. We are in the early stages of building out the infrastructure that enables AI and believe it is too early to identify the potential new leaders in software or application development. For the moment, one company appears to have a monopoly on GPUs that enable AI and large language learning models. Demand for these chips continues to broaden away from the major hyperscalers to other end markets as companies invest more to determine how AI will impact all parts of their business. As AI moves to the edge, opportunities are being created for other suppliers. While we acknowledge semiconductor demand is cyclical in nature, the broadening of end markets and uses is supporting longer duration growth. The capex around AI build-out is rapidly expanding for data centers, memory, semiconductor capital equipment and power suppliers, to name a few.
- **Data centers** – Some of the largest tech companies in the world are embarking on massive capex spending revolving around artificial intelligence — which requires a vast amount of data storage and processing power. U.S. hyperscalers are expected to increase capex significantly, based on company guidance, to support AI-related demand. Global data usage is growing at an increasingly faster rate. The massive amount of data and processing required for AI is accelerating the shift of workflows to the cloud. Investment in AI is driving demand for memory and data storage and the companies that manufacture the components. Increased demand for new AI-enabled data center capacity is directly impacting multiple companies in the industrial sector as well.
- **Semiconductors and semi-cap equipment** – Increased complexity and ubiquitousness of semiconductors has been a benefit to the semiconductor industry for many years. AI is now adding a tailwind to the robustness of demand. Many of the stocks continue to have reasonable valuations and should continue to see outsized growth for the next several years as more semiconductor content is needed to support the build-out of AI infrastructure. Owning the companies that manufacture the chips can be a great way to gain exposure, lessening specific product risk, which is becoming a bigger problem as certain countries move to protect intellectual property and chips that are deemed vital for national security.

- **Electrification and energy sources** – Power demand has essentially been flat for many years. We believe it is entering an era of secular growth. Electricity demand is accelerating from many sources, including data center growth, ancillary AI demand, reshoring, manufacturing activity, the EV transition and fuel source transition. We expect to see power demand rise by 3%+/- over the next five years.[2] Data centers alone are expected to make up 9% of US power demand by 2030 versus 4% currently.[3] Due to this growth, demand is starting to exceed supply. Power efficiency, power management and the ability of utilities to deliver the power will be critical. This is driving investment in both energy generation and transmission, which benefits multiple industrial components and systems companies. The electric grid requires upgrades. As global demand grows, it is becoming harder for the large AI players to build new data centers because of the demand they have for power. Many regions of the country are out of excess power. With long lead times, power and transmission are large constraints. We are seeing nuclear facilities that have been closed come back online. Alternative energy sources should see some rise in demand, but reliability is an issue. Independent power producers are interesting because of their ability to source and price electricity from alternative sources. Several geographies are moving back toward nuclear and natural gas companies may also benefit given the abundant US supply.
- **Thermal management/cooling** – As the demand for data centers grows, so does the need for increased liquid- and air-cooling capacity at these locations, which use a tremendous amount of power and generate a significant amount of heat. The accelerating data center build-out, increased rack power densities and sustainability considerations are driving a shift toward liquid cooling solutions. The HVAC companies should also see above trend growth from these power demands.
- **Reshoring, onshoring** – Companies across the globe are looking to bring manufacturing capacity closer to home and de-risk supply chains. Capex budgets are shifting back toward physical assets after a decade of under-investment. Reindustrialization, reshoring, electrification and digitization trends are powerful drivers of demand. This is benefiting multiple companies in the industrials and materials space, many that are also benefiting from the themes discussed above.
- **Aerospace** – Years of under-investment has led to an aging fleet that can no longer be ignored. In addition, airlines need to become more energy efficient and carbon neutral. This is driving renewed demand for aftermarket and new aircraft. Supply remains constrained due to manufacturing problems across several stages of the supply chain, putting further upward pressure on the supply/demand curve.
- **Infrastructure** – After decades of underinvestment there is renewed focus on the deteriorating highways, bridges, and general infrastructure in the United States. Federal, state and local budgets have increased significantly, driving renewed demand for companies in the materials and industrial sectors.
- **Alternative asset managers** – Alternative asset management is one of the few areas of differentiated growth in the financial services sector. The industry is dominated

by a handful of players and there are high barriers to entry due to deal structure. Companies are launching new strategies, driving fundraising and accelerating fee growth. Market opportunities are expanding into new geographies and the retail/wealth management channel.

- **Life sciences tools** – We believe the cyclical headwinds faced by many of these companies because of COVID-19 and disruption to biotech funding are subsiding. Demand has troughed and we see the opportunity for margin expansion as revenue accelerates. We prefer to own the enablers of research and development, which are high-quality companies that can compound earnings over the long term with less product cycle disruption.

Conclusion

We believe we are in the beginnings of a broad-based capital investment cycle that is the most dynamic we have seen in decades. These changes promise to have broad implications across multiple sectors and are creating exciting investment opportunities in our view. This spending will likely drive earnings growth across the multiple themes that we have identified in this paper, which would meaningfully benefit a range of companies in multiples sectors. We see several markets expanding and new ones starting, and our investment team seeks to identify the companies they believe can succeed in these evolving markets.

While we believe that growth equities can continue to perform well for investors, we caution that not all growth companies are created equal and that an active approach may serve investors better over the long term. Investors need to remain disciplined, maintaining a focus on the underlying drivers of company revenues and earnings. Earnings have historically driven stock prices over the long term, and we believe that remains the case. Market trends are normalizing in our view and stocks are reacting to EPS while their correlations decline. Differences in fundamentals are driving differences in stock price returns. Actively managing around the large benchmark weights can add value given the continued dispersion in returns. Forward earnings expectations are starting to broaden out. As equity prices begin to adjust accordingly, we feel that stock selection can have an impact on long-term returns. ◢

Endnotes

[1] Source: FactSet. Data as of: 31 May 1999 to 31 May 2024. Total returns (gross) are in US dollars for the Russell 1000® Growth Index and Russell Midcap® Growth Index.

[2] IEA (2024), Electricity 2024, IEA, Paris https://www.iea.org/reports/electricity-2024, Licence: CC BY 4.0.

[3] EPRI. "Powering Intelligence: Analyzing Artificial Intelligence and Data Center Energy Consumption." Electric Power Research Institute, Inc., https://www.epri.com/research/products/000000003002028905. Published 28 May, 2024.

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