BlackRock

A stock picker's guide to growth

Point of view with Lawrence Kemp and Phil Ruvinsky

The post-pandemic world is charging into change. Trends that were in play prior to the onslaught of COVID-19 have been accelerated, and many of the companies that were already leading the charge are emerging supercharged. Can valuations of these growth companies continue to defy gravity and deliver for investors? Growth experts Lawrence Kemp and Phil Ruvinsky reveal reasons for optimism.

Lawrence Kemp
Portfolio Manager and Head of the Fundamental Large-Cap Growth team

Phil Ruvinsky
Portfolio Manager and Mid-Cap Growth Lead

Growth typically outperforms amid economic strength. It also has prevailed amid the coronavirus crisis and recession. Why?

Growth has been a standout performer during three key market phases in recent years: the multi-year bull market, the pandemic-driven recession earlier this year and the subsequent snapback and market rally. (See the chart below.)

We believe this has to do with a broad migration in quality that has occurred slowly and quietly over the preceding decade. Growth companies have always been defined as those boasting higher earnings growth than their peers. But we have seen that a much broader cohort of these companies, primarily those offering unique solutions, are able to achieve both higher earnings growth and a stronger competitive moat. This is thanks in part to new technological innovation.

Growth has delivered across time

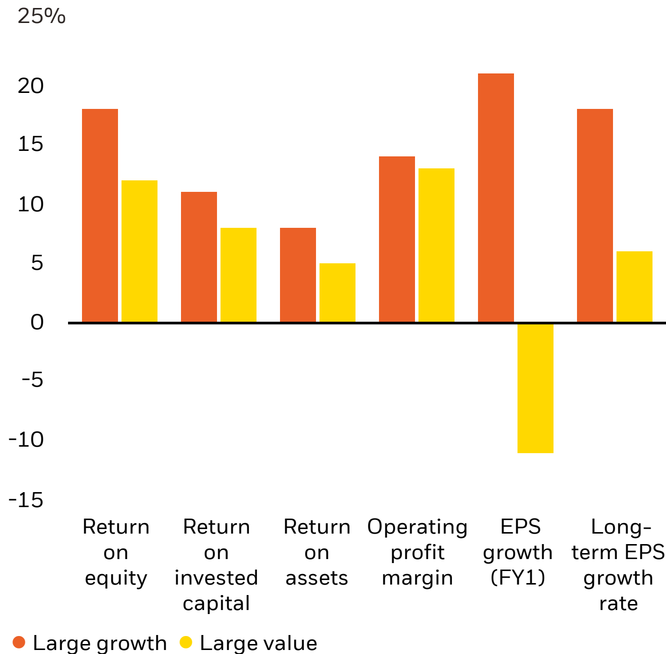
Performance (% return) of selected equity asset classes, Sept. 30, 2020

3 months	1 year	3 years	5 years	10 years	15 years
Large Growth 13.2	Large Growth 37.5	Large Growth 21.7	Large Growth 20.1	Large Growth 17.3	Large Growth 12.0
EM Stocks 9.6	Mid Growth 23.2	Mid Growth 16.2	Mid Growth 15.5	Mid Growth 14.6	Mid Growth 10.5
Large Blend 9.5	Large Blend 16.0	Large Blend 12.4	Large Blend 14.1	Large Blend 13.8	Large Blend 9.3
Mid Growth 9.4	Small Growth 15.7	Small Growth 8.2	Small Growth 11.4	Small Growth 12.3	Small Growth 8.9
Mid Blend 7.5	EM Stocks 10.5	Mid Blend 7.1	Mid Blend 10.1	Mid Blend 11.8	Mid Blend 8.6
Small Growth 7.2	Mid Blend 4.6	Large Value 2.6	EM Stocks 9.0	Large Value 9.9	Mid Value 7.1
Mid Value 6.4	Global Stocks 0.5	EM Stocks 2.4	Small Blend 8.0	Small Blend 9.9	Small Blend 7.0
Large Value 5.6	Small Blend 0.4	Small Blend 1.8	Large Value 7.7	Mid Value 9.7	Large Value 6.4
Small Blend 4.9	Large Value -5.0	Mid Value 0.8	Mid Value 6.4	Small Value 7.1	EM Stocks 5.8
Global Stocks 4.8	Mid Value -7.3	Global Stocks 0.6	Global Stocks 5.3	Global Stocks 4.6	Small Value 4.9
Small Value 2.6	Small Value -14.9	Small Value -5.1	Small Value 4.1	EM Stocks 2.5	Global Stocks 3.7

Source: BlackRock, with data from Bloomberg. Periods ending Sept. 30, 2020. Indexes represented are: MSCI EAFE Index (Global Stocks), Russell 1000 Growth Index (Large Growth), Russell 1000 Value Index (Large Value), Russell 2000 Growth Index (Small Growth), Russell 2000 Value Index (Small Value), Russell Mid Cap Growth Index (Mid Growth), Russell Mid Cap Value Index (Mid Value), Russell 1000 Index (Large Blend), Russell 2000 Index (Small Blend), Russell Mid Cap Index (Mid Blend) and MSCI Emerging Markets Index (EM). Returns shown are annualized for periods of one year and above. **Past performance is not a reliable indicator of current or future results. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged. It is not possible to invest directly in an index.**

Power play: Growth + quality

Quality metrics in growth vs. value stocks, Sept. 30, 2020



Source: BlackRock. Figures shown are a snapshot as of Sept. 30, 2020. Indexes represented are the Russell 1000 Growth (Large Growth) and Russell 1000 Value (Large Value). EPS is earnings per share. See additional notes on page 6. **Past performance is not a reliable indicator of current or future results. Index returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged. It is not possible to invest directly in an index.**

Other factors at play: low inflation due to automation-led productivity improvement and broader use of technology; the globalization of the world economy whereby labor was outsourced to lower-cost regions; and huge investments in smart software and workflow automation to reduce expenses. This has made it more difficult for cyclical companies to raise prices, which has put downward pressure on their earnings and valuations. Growth, meanwhile, has benefited.

In addition, many growth companies today exhibit capital-lite business models, exemplary free-cash-flow generation, relatively lower leverage and cash-rich balance sheets. All of these 'quality characteristics' contributed to growth's relative degree of protection during the downturn. One final relevant variable: Many of these companies were viewed as beneficiaries of a remote working environment, fueled by the tailwind of a corporate digital transformation that has been in place for years. In this way, growth companies were both best prepared for the downturn and most likely to accrue the benefits in its aftermath.

Is the idea that growth performance runs in cycles outdated?

We believe there has been a meaningful change in the U.S. economy that will cause the traditional growth/value cycles as we know them to become more benign, or at least less severe than in years past. This comes down to the fact that we have not experienced a traditional business cycle in the U.S. in over 11 years — and are less likely to in the future given extraordinary government intervention in fixed income markets, persistently low interest rates and structurally low inflation. This means factors that drove value performance in the past may be less likely to drive it in the future, rendering price-to-earnings ratios, price-to-book ratios and dividend yields less effective signals.

Can growth's ascendency continue beyond the pandemic?

We believe so. Investors are looking for a new type of portfolio balance in a low-rate, low-growth world. This could mean not only increased allocation to equities, but greater exposure to growth equities given their strong structural tailwinds.

The pandemic has been an accelerant for many of these firms, but we're focused on the broader implementation of technology by more ordinary businesses. Some of the best companies in our portfolios have been everyday businesses that have put low-cost technology to work to gain market share against competitors. Child daycare companies, salvage auto, pest control, landscaping supplies — companies in these industries have been important drivers of return for us in recent years.

So the opportunity is bigger than the FAAMG stocks?

Absolutely. We see the market for growth stocks as much broader and more robust than the FAAMG companies (Facebook, Apple, Amazon, Microsoft, Google) that dominate headlines. While these large companies have driven the lion's share of return in recent years, we see a much more fertile hunting ground outside of these names than we have in years past. The benefits of innovation and disruption have not just accrued to the big names; and we believe sourcing the best opportunities in the future will require the skill of an active manager since the indices have become so top-heavy.

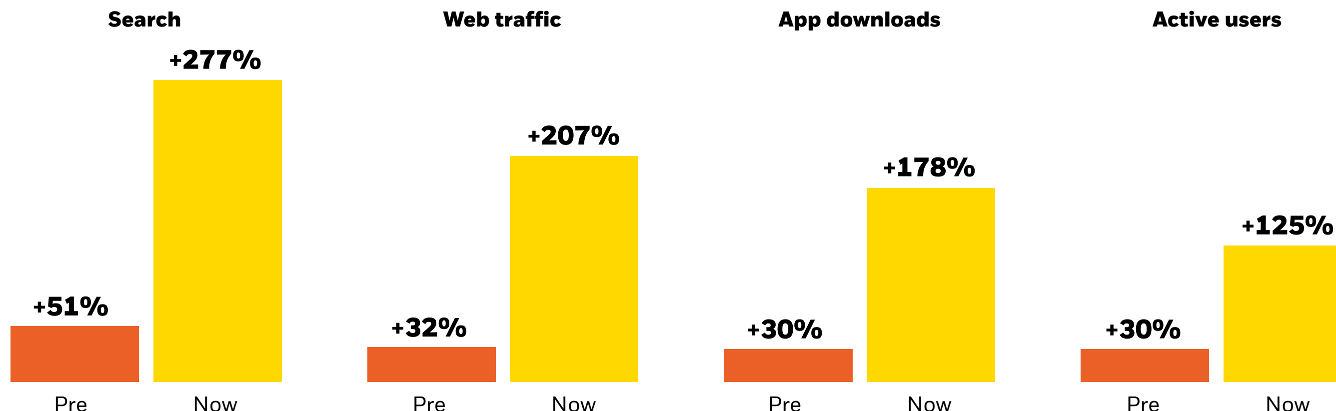
Market leadership is narrow; opportunity is not

Index leaders' contribution to five-year return, Sept. 2020

Index	Index return	Contribution from top-5 performers	Top-5 % of total
Russell 1000 Index	14.1%	4.6%	32.6%
Russell 1000 Growth Index	**20.1%**	**10.0%**	**49.8%**
Russell 1000 Value Index	7.7%	1.6%	21.1%

Source: BlackRock, with data from FactSet as of Sept. 30, 2020. Returns shown are five-year annualized returns. **Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index.**

Telemedicine gaining attention
Growth in key telehealth metrics pre- and post-COVID



Source: BlackRock, as of August 2020. Search data from Google Trends. Web traffic, app downloads and active users (Android only) from SimilarWeb. "Pre" period represents January-February 2020 year-over-year growth rates. "Post" ("now") period represents April-June 2020 year-over-year growth rates.

What are the key trends you see supercharged by COVID-19?

A hallmark of our approach has been to identify growth resulting from structural change and disruption before it is fully priced by the market — and there has been no shortage of these opportunities in the current environment.

The quarantine has resulted in a seismic shift in corporate and consumer behavior, leading to an accelerated digital transformation in multiple industries. Some trends that have been immediately observable are e-commerce, telemedicine and entertainment & data usage in the media space. These are well-documented and obvious beneficiaries of a stay-at-home world, but these are trends that were well in place before the pandemic. We knew, for example, that shopping malls were in danger. We knew that streaming services have been unrelenting opponents of traditional cable companies. Telemedicine has had a slower adoption rate in recent years, but its ease of use may have just become so much more apparent to those using it in pediatrics or for routine check-ups during the first half of this year.

There are less obvious winners as well, where we see important pivots in industry adoption. Examples include digital tours and leasing within real estate, contactless payments and electronic trading within financials, or shifts toward online and away from physical dealerships in the auto space.

What kinds of companies will be market leaders on the other side?

We believe the market leaders of tomorrow will operate capital-lite business models that are focused on things like governance and expense management in addition to driving substantial topline growth across markets. These firms will likely be unencumbered by high fixed costs, unwieldy PP&E (property, plant and equipment) on their balance sheets and high leverage. They will likely be more flexible and nimble than in years past.

Top-performing growth companies in the future will be shareholder centric, more ESG friendly and more focused on driving earnings growth as a primary catalyst for future share price appreciation. In valuing these companies, metrics like price-to-cash flow, free cash flow yield and free cash flow conversion will be paramount. In many ways, these characteristics and metrics have always been critical in the assessment of strong growth franchises; however, these traits will become the rule, rather than the exception, with a more demanding investment community and a keener focus on driving capital appreciation within portfolios.

Has demand for these business models been pulled forward, stealing from the future, or is this growth trajectory sustainable?

Many companies experienced a surge in demand for their products or services as a result of the pandemic and the accompanying digital revolution tied to remote working. While this will inevitably settle some, we don't see it as stealing from the future. We see it as a forced adoption necessary for the survival of businesses in the future, and a trend that will likely continue for companies that want to be competitive in a post-COVID world. In this way, demand may continue to edge higher for providers of these products and services. For example, many consumers swapped gym memberships for connected home fitness equipment. The initial wave in demand may recede, but many of these consumers will be multi-year subscription-payers and likely to become more firmly entrenched in an ecosystem of products offered by a certain company.

We believe this trajectory is sustainable because many of these trends have been solidly in place for years. In many ways this acceleration could also be viewed as a way to clear the market of companies that may have been unprepared, unable or unwilling to adapt, thereby creating even more shelf space for 'survivors' within these industries.

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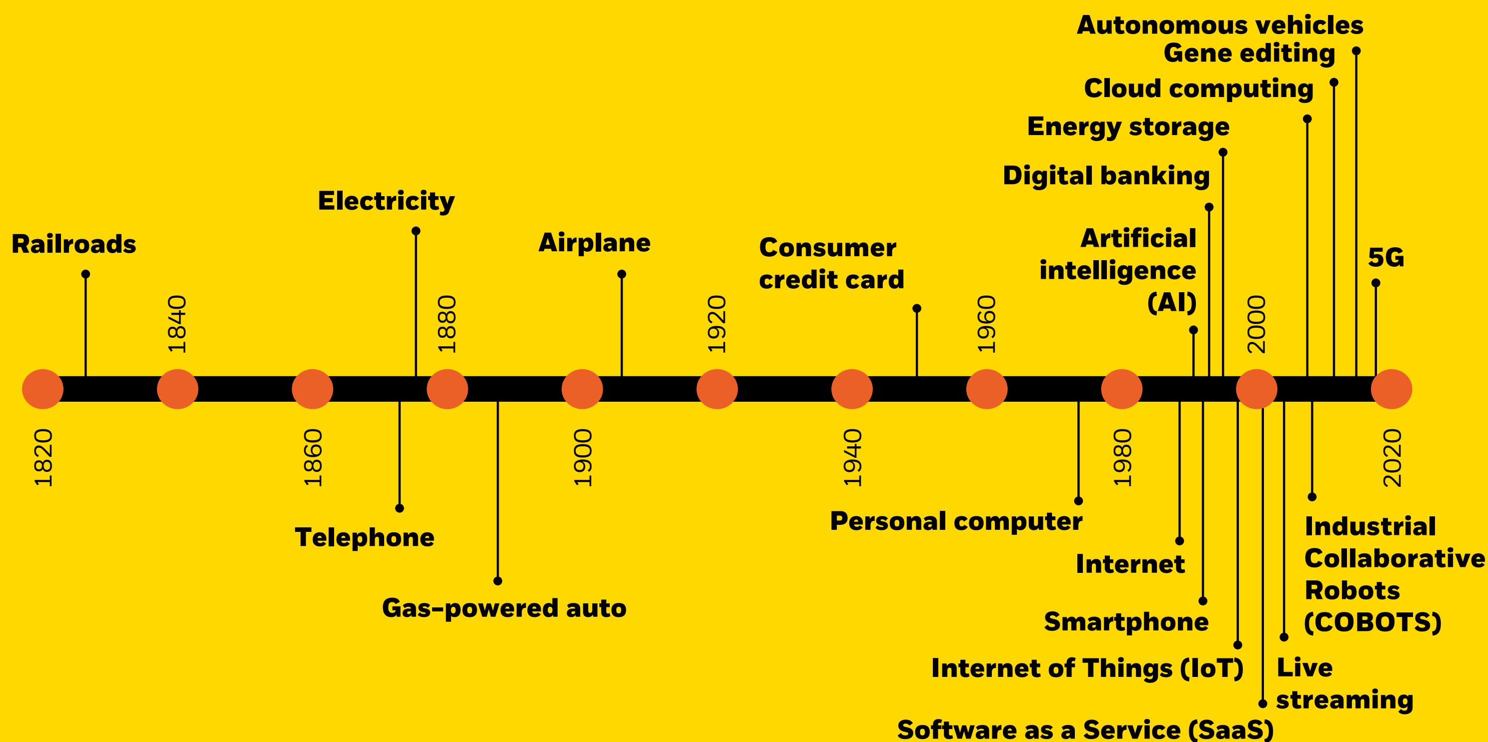
An accelerated rate of change has expanded the opportunity set



Source: BlackRock, as of October 2020. For illustrative purposes only.

How are growth companies different today versus the past?

Growth companies, in the most general sense, are companies that trade at a premium to peers because they are viewed as having better prospects for growth in the future. While growth companies used to be synonymous with creating the 'next big thing,' many of the best companies today are simply implementing technology — using it to their advantage to gain share and grow. This is a marked difference as we analyze growth companies today versus those of years past.

The cost of technology, which has decreased so substantially, has also made it possible for more companies than ever to compete across industries. Trends in e-commerce, web accessibility and its ease of use, contactless payments, point of sale applications and CRM (customer relationship management) software have made businesses smarter and more effective at finding untapped sources of revenue. This trend is both pervasive and systemic not just in the growth market, but in the economy. So the definition of a growth company has not changed, but where we find these companies has most certainly changed over the years.

Historical advances in technology were one dimensional, impacting one industry at a time and taking decades to transform others. Today's rate of change means the implications are farther reaching than in the past, often occurring across many industries at once. (See the illustration above.)

Adaptation is key to continued growth. How do you identify companies with the foresight and ability to adapt?

The technological advancements we've discussed have not evoked a rising tide that has lifted all boats. The cost of doing business may have come down, but the gains will still accrue to those most ready to pivot and change direction when opportunity arises. Innovation has long been the backbone of growth companies. But elasticity, creativity and grit will be the drivers of those most likely to be high performers in the future.

Our favorite technology companies, for example, are providing solutions that enable leading franchises in other sectors to manage their businesses better, lower costs and improve margins. In today's market, we believe it is not about the *creation* of tech, but rather its *implementation* across industries. This is why corporate margins in the U.S. have been steadily higher than in other parts of the world: Companies across the market are embracing digital solutions to drive better outcomes while also exercising greater labor flexibility.

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Are you concerned about lofty valuations?

Valuations have been a big part of the discussion around growth stocks in recent years, and the magnitude of outperformance, especially against value stocks, has been well documented. In today's pandemic-oriented market, the questions have centered on: How can these companies be so highly valued when the economy is struggling? Isn't there a disconnect? We believe that in parts of the market, there is. But it's important to remember that the current valuation of a company comes from discounting future cash flows. In a low-rate world, businesses with a long duration and the ability to generate lots of free cash flow deserve to trade at a higher multiple given the low yields offered by other asset classes.

Best-in-class growth companies may experience bouts of volatility, but we see long-term, supportive trends firmly in place. And today the market is betting that this cohort of companies will drive sizably higher growth in years ahead.

All of that said, we can be more comfortable paying a premium for a company when we can see quality. Quality today comes in the form of free-cash-flow generation, sensible leverage and earnings growth backed with a strong competitive stance in the market.

What does all of this mean for active stock pickers like yourself?

We believe the pandemic and its impact on companies has ushered in what may be a new wave for active managers. The preceding decade, during which all stocks seemed to move up together, was a difficult one for active fund managers. Today, we see more dispersion, a greater separation between winners and losers in the market, and an environment with the likelihood for higher volatility — all of which have traditionally been positives for active managers.

While concentration issues in the large-cap indices can present problems, we also believe there are opportunities beyond the FAAMG stocks most covered by the financial media. The large-cap universe is teeming with high-quality companies, and the mid-cap space presents a slate of up-and-comers that have unique products and solutions we believe will enable them to take market share and grow. Innovation and disruption are here to stay, and these trends make it an incredibly exciting time to be an active manager.

> **“We believe the pandemic and its impact on companies has ushered in what may be a new wave for active managers.”**

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Additional notes related to page 2 chart: Return on equity (ROE) divides a company's net income by shareholders' equity to measure return on net assets. Return on invested capital (ROIC) is net operating profit after tax/invested capital, measuring a company's return after costs are paid. Return on assets (ROA) assesses how profitable a company is relative to its total assets. Operating profit margin is the ratio of operating income to net sales. Earnings per share is a company's net profit divided by the number of shares outstanding. All help to assess a company's profitability.

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