FROM THE DESK OF THE CIO

Growth Becoming “The Market”?

July 20, 2018

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All too often, investment consultants and mutual fund research houses bifurcate the public equity universe into two camps, growth or value, and the blend of the two is often referred to as the “stock market.” These two diametrically opposed style boxes, we are told, are separated by a valuation dividing line that an index provider defines.[1] Value stocks are your cheaply-priced, often higher dividend paying legacy companies, while growth stocks often contain painfully high valuations and generate little free cash flow today in hopes of larger profits down the road. These two styles are often diametrically opposed philosophically, with one or the other’s fall from relative-performance favor being hailed as temporary. Managers firmly grasping to one style then attempt to provide reassurance that mean reversion will occur eventually and rational minds will prevail, inevitably causing the investment cycle to snap back in their favor. As tempting as it is to contribute to the debate of which style box will be in/out of favor, we think a far more insightful exercise is to take a step back and attempt to identify the drivers that cause relative under-/out-performance.

The crux of this analysis is that far more of the stock market, as it is often defined today, is being driven by companies traditionally considered to be of the growth style, whereas value is becoming increasingly synonymous with business models more prone to disruption. Therefore, an ability to discern “disruptor” versus “disrupted” is far more valuable to determine which stocks will likely be winners over the next decade, rather than anchoring an investment process to arbitrary, static valuation boundaries.

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Business model disruptions have become pervasive across all economic sectors, and the root of their driving force is usually technology based. Take, for example, the ability to sequence the human genome and its effect across the entire healthcare industry. The opportunity to deliver individualized treatments for diseases that previously were too cost prohibitive can be unleashed by our ability to drive the cost to sequence a single genome from $100s of thousands a decade ago to sub-$1,000 today and to sub-$100 in the not-too-distant future *(see chart 1)*. On the “disrupted” side of this equation exist a slew of pharmaceutical companies selling profitable drugs that manage symptoms related to any number of these diseases. Meanwhile, large cap pharma equity trades at “cheap” valuations and offers attractive dividend yields *(see chart 2)*. Investors who flock to this sub-sector of issuers due to valuation attractiveness alone, without careful consideration of these competitive dynamics or ability to hedge in a portfolio context, open themselves to considerable factor risk.

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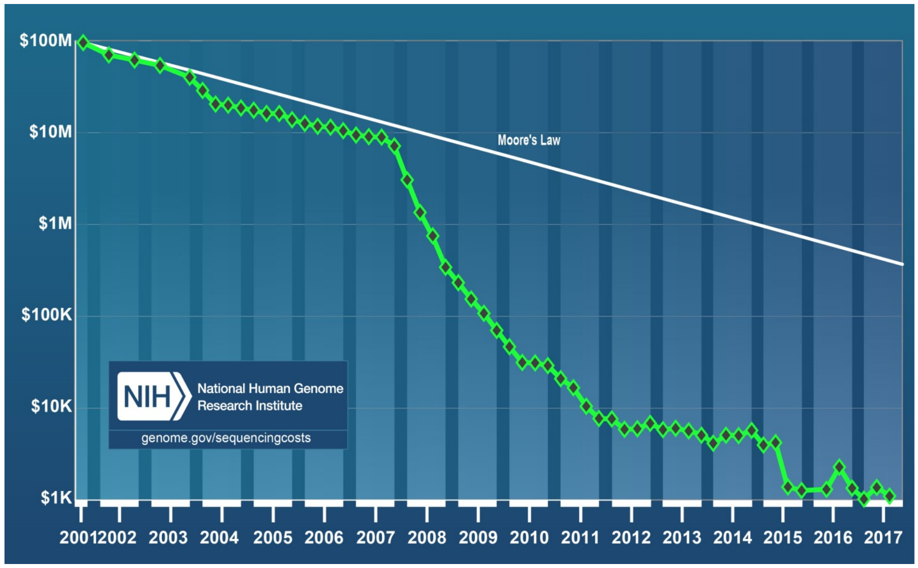
Chart 1: Sequencing Cost per Genome (green line)



Source: National Human Genome Research Institute.

The opportunity to deliver individualized treatments for diseases that previously were too cost prohibitive can be unleashed by our ability to drive down the cost to sequence a single genome.

Chart 2: Pharma Peer Group Valuations

Name	Ticker	Div. Yield (last 12 mos.)	P/E (next 12 mos.)
Pfizer Inc.	PFE	3.55%	12.0x
Eli Lilly and Co.	LLY	2.46%	16.0x
Johnson & Johnson	JNJ	2.71%	14.5x
Bristol-Myers Squibb Co.	BMY	2.80%	15.6x
Allergan plc	AGN	1.61%	10.2x
AbbVie, Inc.	ABBV	3.04%	11.1x
Merck & Co., Inc.	MRK	3.08%	13.8x
Group Avg.		**2.75%**	**13.3x**
S&P 500		1.79%	16.7x

Source: FactSet, pricing as of 7/9/2018.

Companies with better ability to pierce through the veil of how these disruptions will impact their business models and, in turn, devise strategies today to be in the driver's seat, stand far better odds of survival than those with inferior forecasting ability.

Alternatively, consider the increasing amount of video we consume on our phones and tablets and the ripple of impacts across mobile carriers' network designs, entertainment content creation, and advertising spend by companies trying to sell us products. These same devices can also pinpoint our location with far greater precision today than in the past, allowing us to hail an on-demand car service to our exact curbside location. None of these disruptions occur overnight, but companies with better ability to pierce through the veil of how these disruptions will impact their business models and, in turn, devise strategies today to be in the driver's seat, stand far better odds of survival than those with inferior forecasting ability.

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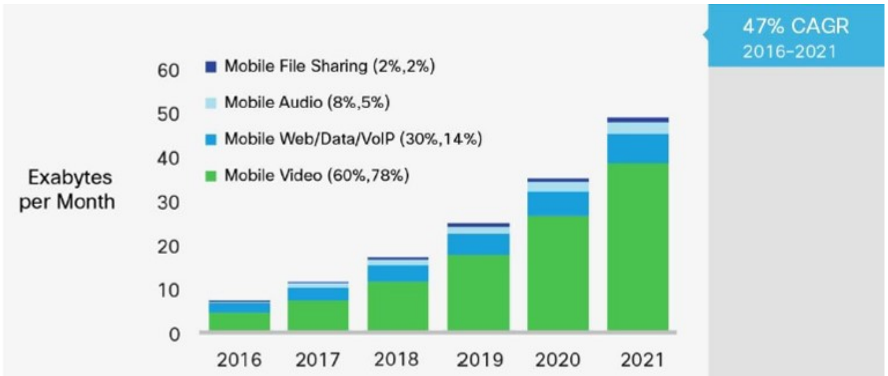
Chart 3: Mobile Data Traffic Composition, 2016-2021



Figures in parenthesis refer to 2016 and 2021 traffic share, respectively.
Source: Cisco VNI Mobile, 2017

As the broader stock market indices aggregate the results of both growth and value, the composition today looks very different than it did a decade ago.

When you sort through the publicly traded equity universe, you find companies aggressively innovating down the path of their disruptive opportunity set, and you also find others with crosshairs on their back. These scenarios often can be used to describe many companies traditionally found in the value versus growth camps. As the broader stock market indices aggregate their results, say the S&P 500 or the Dow Jones Industrial Average ("the Dow"), the composition of both indices today looks very different than it did a decade ago. For example, observe how the constituents of the Dow have changed over time. The thirty constituent stocks that make up the Dow are chosen by a committee tasked with selecting companies that have "an excellent reputation, demonstrate sustained growth and are of interest to a large number of investors."[2] Looking at the cohorts of additions and subtractions chosen by this process, you see Apple [AAPL] displacing AT&T [T] in 2018, and Citigroup [C] and General Motors [GM] exiting at the same time as Cisco Systems' [CSCO] 2009 addition. Intel [INTC] and Microsoft [MSFT] also displaced the cohort of Chevron [CVX], Sears Roebuck [SHLD], Goodyear Tire [GT] and Union Carbide [acquired by Dow Chemical in 2001] back in 1999. In fact, today there are four NASDAQ-listed issuers that comprise the Dow, which traditionally was viewed as an exchange containing more volatile issuers. As such, even the Dow has become more tech-centric, embracing select gatekeepers of disruptive innovation as a natural outcome of its efforts to remain a relevant barometer of the market.

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Another perspective that reveals more of a shift in the market composition is to overlay the list of issuers in the S&P 500 with those of the Russell 1000 Growth Index. Unlike the Dow's more arbitrary approach of selection by committee, S&P and Russell have more quantitative methodologies for determining their respective constituency composition. The former represents 505 large-cap issuers with eligibility criteria based on market capitalization, liquidity, and domicile, governed by rules promulgated by S&P Global.[3] The Russell 1000 Growth Index contains 542 constituents that rank higher among price-to-book, 2-year projected earnings growth, and 5-year historical sales-per-share growth, as determined by FTSE Russell.[4] Comparing issuer overlap between the two back in 2000, you would find

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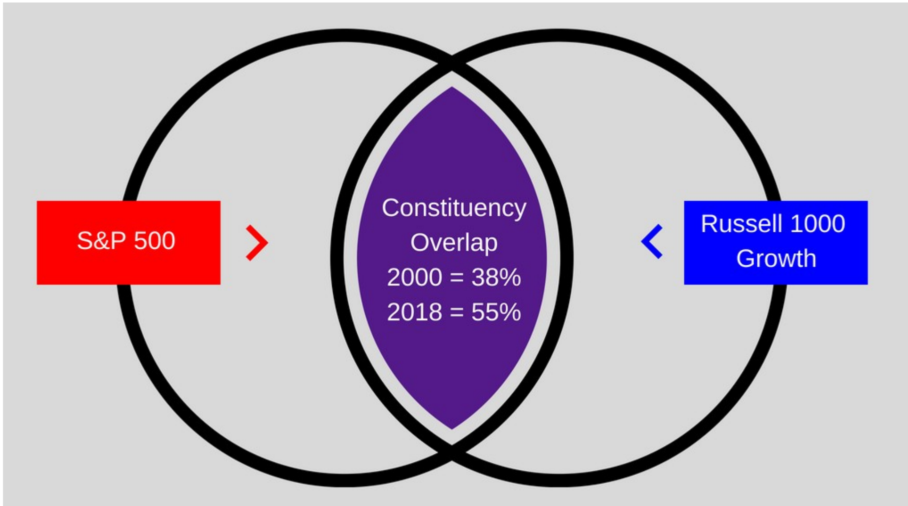
The issuer overlap between the S&P 500 and the Russell 1000 Growth was 38% in 2000 in terms of name count; today, that ratio is 55%.

190 stocks in both indices, i.e. the Russell 1000 Growth had 38% overlap with the S&P 500. Today, that ratio is 55% with 277 names in common between the two.[5] Therefore, two separate methodologies by separate index companies have constituents with increasing overlap, despite one being a proxy for the broad market, and the other a proxy for growth.

Chart 4: Growth Becoming the Market, Name Count Overlap



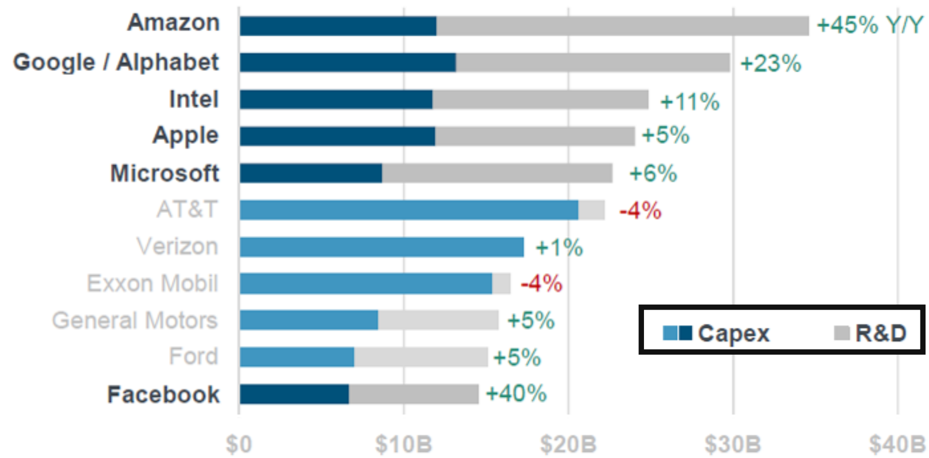
Source: FactSet.

We believe that the underlying drivers creating and destroying value among the publicly traded universe are causing the winners to crowd out the losers at the aggregate level

We'd argue that this growing position overlap is not a matter of the formula gate-keepers choosing to wade deeper into the warmer waters of growth-style companies. Instead, we believe that the underlying drivers creating and destroying value among the publicly traded universe are causing the winners to crowd out the losers at the aggregate level. In essence, every boardroom that's tasked by its public shareholders to create economic value is eyeing the next decade and questioning how it will achieve that goal. The key tools to unlocking that code are becoming more and more deeply rooted in technology, whether its artificial intelligence, increased automation, data monetization, digital transformations, etc. An analysis of the largest research and development ("R&D") and capital expenditure ("capex") spenders reinforces this conclusion *(see chart 5)*.

Unlike prior periods of irrational exuberance, the economics of investment can be meaningfully tangible. Prior tech-related capex deployments had to contemplate large footprints of server racks deployed within expensive data centers teaming with skilled engineers tasked with managing proprietary, closed systems. Today with the swipe of a credit card, companies can spin up compute workloads from a cloud provider with usage billed like a utility. For example, if a company needs to run highly compute-intensive deep learning neural networks, it can forgo the capex outlay of millions of dollars for graphics cards with hi-speed interconnects by instead running an Amazon Web Services' EC2 P3 instance with eight NVIDIA Tesla

Chart 5: Total US Public Company R&D + Capex Spenders, 2017



Dark blue bars denote technology companies, light blue denote non-technology sector companies.
Source: Kleiner Perkins Internet Trends 2018.

V100 GPUs, 488GB of memory, 64 virtual CPUs, and 25 Gbps network bandwidth for $10/hour.[6]

Microsoft, now the owner of LinkedIn following its 2016 acquisition, recently supported this analysis by sharing interesting primary data that demonstrates how non-technology companies are becoming more tech-centric in their hiring plans. CEO Satya Nadella commented, "According to LinkedIn data, software engineering roles in industries outside of tech, such as retail, healthcare, and energy, are seeing double-digit growth year-over-year, 25% faster than the growth of developer roles in the tech industry itself."[7]

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-Satya Nadella, CEO of Microsoft

Summary

We are not tossing aside the time-tested building blocks of fundamental analysis, nor are we professing that index formula gatekeepers are intentionally skewing their market benchmarks towards growth over value. Instead, we believe a confluence of factors are contributing to a larger percentage of the equity market being driven by companies creating and destroying value within their respective industries. This, in turn, causes the winners to crowd out more of the losers at the aggregate level. The ability to identify these trends will become more imperative for any investment manager with hopes of outperforming the broad market indices. We also believe that an understanding of technology is a prerequisite, given it often is at the core of many disruptive trends.

Citations:

1 *For example, S&P 500 Growth vs. S&P 500 Value, Russell 1000 Growth vs. Russell 1000 Value.*
2 *Source: S&P Dow Jones Indices, "Dow Jones Averages Methodology."*
3 *S&P Dow Jones Indices: Index Methodology, June 2018.*
4 *FTSE Russell, Construction and Methodology, Russell U.S. Equity Indexes v3.3.*
5 *Source: FactSet. Analysis of current overlap as of June 30, 2018, utilizing iShares Core S&P 500 ETF [IVV] and iShares Russell 1000 Growth Index ETF [IWF] as proxies for their respective benchmarked index.*
6 *Source: Amazon Web Services.*
7 *Source: Microsoft's acquisition of GitHub conference call.*

About the Authors

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Mike joined SWS in 2017 as its CIO and leads portfolio management, risk management and research for the firm. Before joining SWS, Mike was a portfolio manager on $4 billion of long-only equity portfolios at the Ohio Public Employees Retirement System (OPERS).
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Prior to OPERS Mike was responsible for investment bank equity research at FBR Capital Markets. He received his Bachelor of Science in Economics, Finance concentration, from the Wharton School at the University of Pennsylvania and is a CFA® charterholder.

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