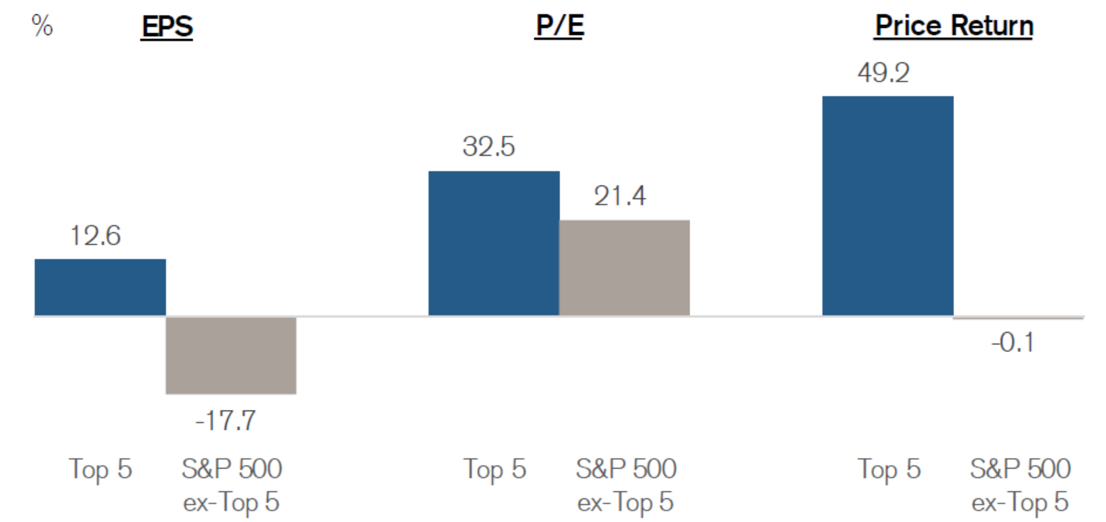
August 4, 2020

The Price of Growth

Year over Year Contribution of EPS and Price to Earnings to Returns



Source: Standard & Poor's, Thomson Financial, FactSet, Credit Suisse

As active managers investing alongside our clients, our team's incentive is to create the best possible portfolios for our clients to meet stated objectives. While our team routinely scrutinizes holdings in our portfolios through our quintiles process, force ranking a portfolio's holdings on a one to five basis, we also actively challenge our positions and each other on a daily basis. This summer, our most intense discussions surround equity market valuations and market structure. The chart above encapsulates the challenge – how much to pay for growth in the top five stocks in the market (Apple, Microsoft, Amazon, Alphabet, and Facebook). The good news is that we own many of these across our strategies that target the growth and value segments of the market, however, as the bar chart on the far right shows, the performance of these stocks have been remarkable relative to the rest of the market.

The chart was taken from a Credit Suisse report that is similar to others comparing 2020 to 2000 and the concentration of large index weights (22% today in the top five versus 18% then); however, while we believe history does not repeat but does often rhyme, we would point to the early 1970's which we have found helpful in our discussions.

Unlike 2000 when many top performing stocks were unprofitable, investors gravitated to growth stocks after a bear market in 1968-1970 where the S&P 500® Index fell by over 35%. Similar to the first quarter of this year, growth stocks outperformed small caps and value stocks and, perhaps because of the economic uncertainty, investors flocked into companies they knew. These brand name growth stocks, known as the Nifty Fifty, included names such as Coca-Cola, McDonald's and IBM. By the end of 1972, the Nifty Fifty had a price-to-earnings ratio of 42x versus the S&P 500® Index at 19x and a growth rate of over 1.3x the index.

Jeremy Siegel, a professor of finance at the Wharton School of the University of Pennsylvania, wrote a paper in 1998 entitled, "Valuing Growth Stocks: Revisiting the Nifty Fifty," where he points out that:

- investors must pay for growth,
- but cannot "pay any price,"
- and most importantly, must be diversified

2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020 YTD
Quality Defensives 34.8%	Quality Defensives -3.2%	Financials 29.8%	Quality Growth 12.2%	Financials 15.0%	Quality Defensives -0.6%	Cyclical Value 12.8%	Hyper Growth 54.7%	Stable Yield 0.9%	Quality Growth 21.8%	Hyper Growth 14.7%
Financials 26.7%	Stable Yield -4.2%	Quality Defensives 28.9%	Quality Defensives 6.3%	Stable Yield 11.9%	Quality Growth -1.2%	Financials 4.8%	Quality Growth 42.9%	Quality Defensives -4.5%	Cyclical Value 16.7%	Quality Growth -2.1%
Stable Yield 25.6%	Universe -20.1%	Stable Yield 26.3%	Hyper Growth 4.5%	Quality Defensives 11.6%	Hyper Growth -4.9%	Universe 4.6%	Cyclical Value 38.7%	Financials -13.1%	Hyper Growth 13.6%	Quality Defensives -6.6%
Universe 23.9%	Quality Growth -21.1%	Universe 23.6%	Stable Yield 3.4%	Quality Growth 8.7%	Stable Yield -5.5%	Stable Yield 4.5%	Universe 33.9%	Universe -13.6%	Universe 12.9%	Universe -10.9%
Hyper Growth 22.7%	Financials -23.7%	Quality Growth 22.4%	Universe 2.3%	Universe 6.2%	Universe -6.6%	Quality Growth 2.8%	Financials 31.6%	Cyclical Value -15.2%	Financials 10.1%	Cyclical Value -12.4%
Quality Growth 20.7%	Hyper Growth -23.9%	Cyclical Value 17.5%	Financials 2.2%	Hyper Growth 2.9%	Financials -10.2%	Quality Defensives 0.7%	Quality Defensives 29.5%	Quality Growth -19.4%	Quality Defensives 9.5%	Stable Yield -16.2%
Cyclical Value 19.4%	Cyclical Value -29.1%	Hyper Growth 7.2%	Cyclical Value -4.5%	Cyclical Value -0.6%	Cyclical Value -12.4%	Hyper Growth -10.4%	Stable Yield 24.6%	Hyper Growth -25.6%	Stable Yield 6.7%	Financials -18.7%

Source: Credit Suisse HOLT. Large cap APxJ companies. Data as of end June 2020.

It is on these last two points where our internal discussions are the most dynamic. As the chart on the first page highlights, the top five have returned over 3.5x their earnings growth this year and can all be considered generally closely aligned with the technology sector. The chart above highlights that the quest for growth in 2020 has been global, including regions such as Asia where our strategies also have exposure. By engaging in rigorous assessment and employing a process than combines growth and value, we believe we can deliver clients an opportunity to achieve both above average returns with below average risk over time.

As always, thank you for your interest and trust managing your investments.

Charles J. Wittmann, CFA®, Executive Director, joined Sterling Capital Management in 2014 and has investment experience since 1995. Chip is an equity portfolio manager. Prior to joining Sterling, he worked for Thompson Siegel & Walmsley as a portfolio manager and (generalist) analyst. Prior to TS&W, he was a founding portfolio manager and analyst with Shockoe Capital, an equity long/short hedge fund. Chip received his B.A. in Economics from Davidson College and his M.B.A. from Duke University's Fuqua School of Business. He holds the Chartered Financial Analyst® designation.