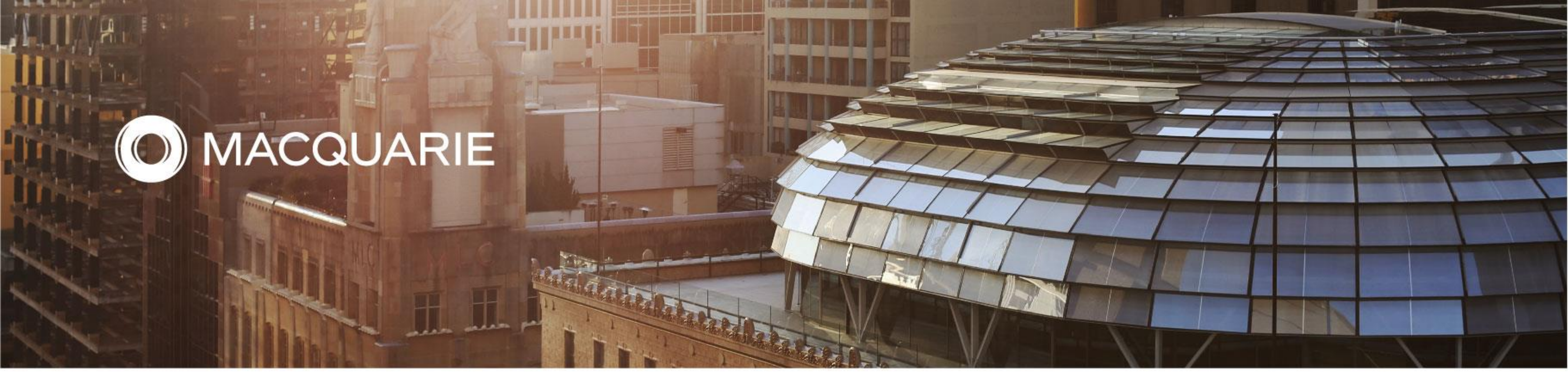


Investment Strategy Update #97

Why we still like "growth" stocks and strategies

- After multiple years of strong outperformance, growth stocks and strategies are suffering from multiple headwinds vis-à-vis value stocks and strategies. This started with a stronger than expected post pandemic economic rebound which drove a recovery in cyclically sensitive value stocks and has continued as a deteriorating inflationary outlook has raised expectations of a faster rate tightening cycle.

- The result has seen many high multiple growth stocks suffer significant valuation corrections as the prospect of an end to ultra-low interest rates undermines lofty P/E multiples versus more reasonably priced value stocks.

- We have long held a preference for growth over value stocks and strategies for portfolios that have medium to long term wealth creation objectives. While there will be periods when the cyclical outlook improves and value stocks take leadership, these periods are getting both shorter and shallower and a tilt toward high quality growth stocks, which have a strong valuation overlay, are expected to provide stronger *'through the cycle"* returns despite short periods of reversal.

- While the rotation out of growth stocks and the magnitude of underperformance in recent quarters has been large, we don't think it signals a prolonged period of value stock outperformance. There is no evidence to suggest we are entering a prolonged period of above trend economic growth that will benefit cyclical stocks or that inflation will require years of higher and overly restrictive interest rate policy.

- We think gaining exposure to areas of strong structural growth over broad economy wide growth remains a preferred strategy for equity investors in order to avoid cyclical shifts and the need to make constant tactical tilts. Not all growth stocks and strategies are created equally. Growth investing is not dead, even under a rising interest rate backdrop.

Why did growth strategies perform so well post the global financial crisis?

Investors need sensible and well-balanced equity strategies that are consistent with their wealth creation investment goals. At Macquarie, we have long held a preference for *"through the cycle"* equity strategies which have a higher-than-average growth and quality bias. We then supplement these strategies with tactical overlays when required. Our tilt towards growth and quality biased equity managers and funds has been driven by three key factors.

- First, there is evidence that a *"growth at a reasonable price"* equity strategy over a *"growth at any price strategy"* can provide reasonably consistent returns through the cycle even if there are periods when more value-oriented strategies do better

- Second, our desire to avoid chasing tactical swings in the market and the need to rotate between growth and value strategies when economic and equity market conditions change.

- And third, because we want equity exposures that provide strong structural and not only cyclical earnings upside as this allows us to gain leverage to pockets of growth rather than economy wide growth.

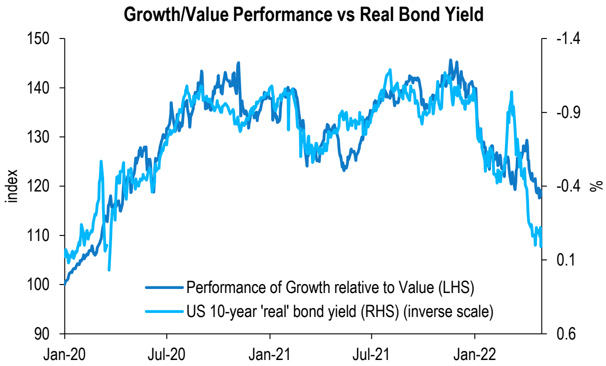
Long term returns favour Growth stocks despite recent underperformance

	1m	3m	1yr	3yr	5yr	10yr
MSCI World Index	-6.9%	-6.4%	0.3%	38.4%	68.3%	207.3%
MSCI World Growth	-10.5%	-10.6%	-6.1%	47.5%	90.2%	250.2%
MSCI World Value	-3.5%	-2.5%	6.2%	26.5%	44.7%	161.4%
S&P500 Index	-8.7%	-8.2%	0.2%	47.6%	89.7%	260.0%
S&P500 Growth	-12.5%	-12.7%	-3.2%	54.6%	112.9%	313.8%
S&P500 Value	-4.9%	-3.5%	3.2%	35.8%	61.4%	196.7%
MSCI Australia	-0.5%	9.7%	10.8%	30.3%	50.0%	157.7%
MSCI Australia Growth	0.7%	7.3%	7.9%	24.2%	63.2%	149.6%
MSCI Australia Value	-1.5%	11.7%	13.1%	32.4%	32.6%	153.0%

Source: Factset, MWM Research, May 2022

We acknowledge historical evidence shows that value has outperformed growth over the long term. But this outperformance is not consistent through time and there are long periods where one style is in / out of favour as has been the case since the end of the global financial crisis where growth stocks have benefited from low inflation, low interest rates and low economic growth.

Growth stocks have moved closely with real bond yields over the past 2 years both up and down



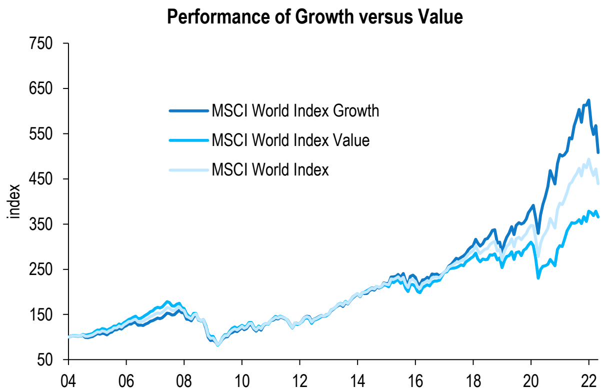
Source: FactSet, MWM Research, May 2022

But, over the past year as economic activity has rebounded off the back of extraordinary levels of monetary and fiscal policy stimulus, we saw the first wave of outperformance by value stocks and in particular those leveraged into the economic recovery. This trend was further reinforced as rising inflation and the prospect of an end to ultra-low policy rates began to undermine growth stock valuations and open them up to disappointment.

But not all "growth" strategies are created equally

All things equal, an environment of rising and/or high inflation and one that is accompanied by rising interest rates will tend to favour value stocks which are not hurt as much by a rising discount rate because they tend to trade on lower valuation multiples.

Growth strategies have corrected sharply since 2021 but have still strongly outperformed since 2017

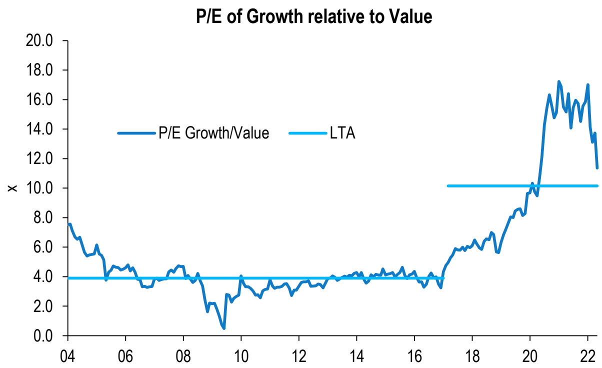


Source: FactSet, MWM Research, May 2022

But not all growth strategies are the same and broad-based benchmarks (such as value and growth) can be misleading and not wholly representative of performance when other factors such as valuation are taken into consideration. At Macquarie, our preference is on a narrower subset of the "growth" universe and on buying and recommending strategies that target *"growth stocks at a reasonable price (GARP)"* over *"growth stocks at any price (GAAP)"*. While these are both growth strategies, GARP has a strong valuation overlay while GAAP does not.

There is a key limitation to this type of growth strategy, but it also comes with some key benefits. GARP strategies will not usually rise as much as GAAP strategies when inflation and rates are low because they will not experience the same level of valuation expansion and hence price upside. But equally, they are unlikely to fall as much when inflation and rates begin to rise because they derive a greater proportion of their value from near term earnings and trade on less lofty valuations.

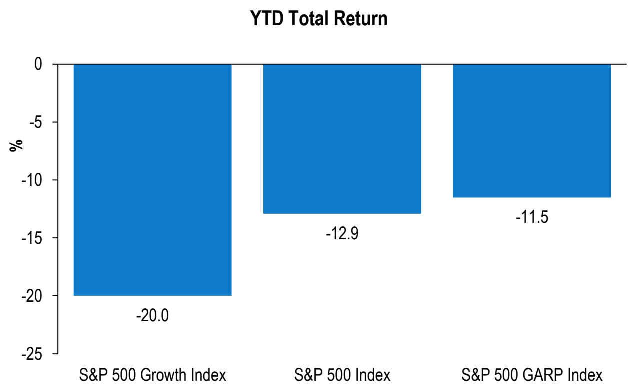
Growth stocks still trade expensively versus Value stocks



Source: FactSet, MWM Research, May 2022

For instance, Microsoft or Apple are considered GARP stocks because they trade on relatively low growth stock valuations but with above average growth prospects. In comparison stocks like Netflix or Paypal are considered GAAP stocks because they also have above average growth but trade(d) on extreme valuations. This makes them highly vulnerable to rising interest rates as is the case now.

GARP has outperformed Growth in the sell off

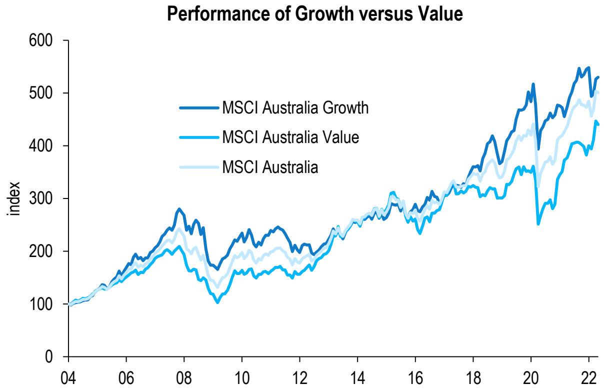


Source: FactSet, MWM Research, May 2022

What does this mean for growth stocks and strategies?

Our key message is that while growth stocks are indeed vulnerable to rising interest rates and this is likely to be a feature of the macroeconomic environment for the next 12-18 months, the degree of sensitivity to higher rates will vary significantly. All things equal, the higher the valuation, the more vulnerable the valuation is to higher interest rates. Stocks which tend to trade on the highest multiples are either those which have low and/or no earnings or which have growth prospects that stretch far out into the future. This is a trend we have seen evident in the latest growth stock sell-off, particularly in the US, where the valuation dispersion is extremely wide (particularly amongst technology stocks).

Australian growth stocks have not corrected as dramatically as global growth stocks



Source: FactSet, MWM Research, May 2022

But we think it is wrong to paint all growth stocks with the same brush. A strategy that has a sensible valuation overlay is not as vulnerable to rising interest rates as one which is focused on gaining exposure to growth at any cost and this can be seen in recent performance trends both in Australia and abroad.

We are in a macroeconomic environment that, all things equal, will tend to favour stocks that trade on value multiples and are less sensitive to the discount rate. This is why growth stocks and funds are underperforming. However, we think the window for value stock outperformance will be relatively short based on Macquarie's macroeconomic view that inflation will be transitory. In addition, we don't think we are entering a prolonged period of above average economic growth which means the cyclical tailwinds for value are not likely to persist.

Finally, while the period of growth underperformance might not be over, the rationale for preferring growth strategies that have a strong valuation and quality bias remain in place. We like the fact that these strategies give investors "through the cycle" exposure to structural growth opportunities and that it does not require making ongoing tactical shifts between the different styles which can be difficult to time.

We recommend investors who have a medium to long term outlook maintain a bias towards GARP focused strategies with the option of supplementing these with tactical allocations to value strategies but not the other way around.

Macquarie WM Investment Strategy Team

The report was finalised on 2 May 2022.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

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