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Growth Stocks: The Good, the Bad and the Ugly

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Eugene Barbaneagra
Portfolio Manager

Snapshot

- Growth by itself does not generate excess returns—profitability matters.
- The global economy began returning to normal in 2021, and so did the relative investment returns provided by growth strategies.
- While trendy growth stocks grab headlines (and sometimes generate fast money for speculators), we believe that quality companies make for good investments.

A positive relationship between revenue growth and the price of company's stock likely seems intuitive. It follows, then, that rising sales should lead to growing profitability, which should result in a rising stock price. Consider, for example, a coffee shop. Opening a second location just a few blocks down the same street as the first location would provide a second source of sales and, theoretically, an increase in revenue.

However, the reality may not be as lucrative as the theory. With a choice of two coffee shops just a short stroll from each other, some customers would likely switch from the first location to the second—resulting in zero revenue growth. Even if the second location attracts new customers, rather than simply offering existing customers an alternative location at which to make their purchases, successful businesses tend to attract competitors.

As newcomers attempt to imitate the original shop's approach, a fall in prices and obtainable profit margins is not necessarily imminent but almost always inevitable. Even businesses that manage to dominate their competitors and achieve long-term success can face challenges. For example, a company that develops a dominant market share may attract regulatory scrutiny—and such oversight could curtail business activity or even breakup successful business models.

Growth ≠ rising stock prices

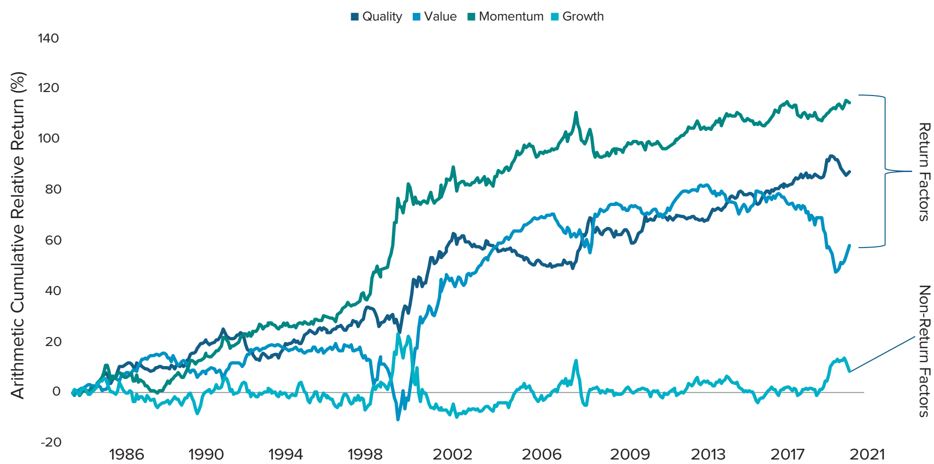
Where revenue growth and stock prices are concerned, long-term historical analysis does not support this supposedly intuitive assessment, as shown in Exhibit 1. While there have been short-term periods of excitement for growth stocks and growth-oriented investment strategies (including the 1999-to-2000 and 2019-to-2020 periods), they did not last. On the other hand, value, momentum and quality have each historically provided significant long-term results. We could not find any credible research documenting a positive relationship between growing revenues and stock-price performance.

All references to performance are in U.S. dollar terms unless otherwise noted.

Equity factors measure and potentially capture underlying drivers of return:

- Growth stocks exhibit revenue growth above that of the broader market.
- Momentum stocks are companies whose earnings and share price performance are trending higher.
- Quality stocks are companies with high and stable profitability and strong balance sheets.
- Value stocks are those that are trading at a discount versus their market and industry peers.

Exhibit 1: Not All Equity Factors Lead to Excess Returns



Source: SEI, using data from FactSet, Axioma, and FTSE Russell. Data is for U.S. equities, based from the Russell 1000 Index. The Russell 1000 Index represents the top 1000 companies by market capitalization in the U.S. Factor portfolios are constructed using the top one-third of the liquidity-weighted index, grouped by the respective factor style and rebalanced quarterly. The metrics are composites of underlying ratios that SEI has determined to be the appropriate measure of each factor. Factor performance is shown relative to the capitalization-weighted market. Factor and index performance do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Data refer to past performance; past performance is not a reliable indicator of future results. Updated to 3/31/2021, using SEI's most recent composite methodology.

Rare ≠ good

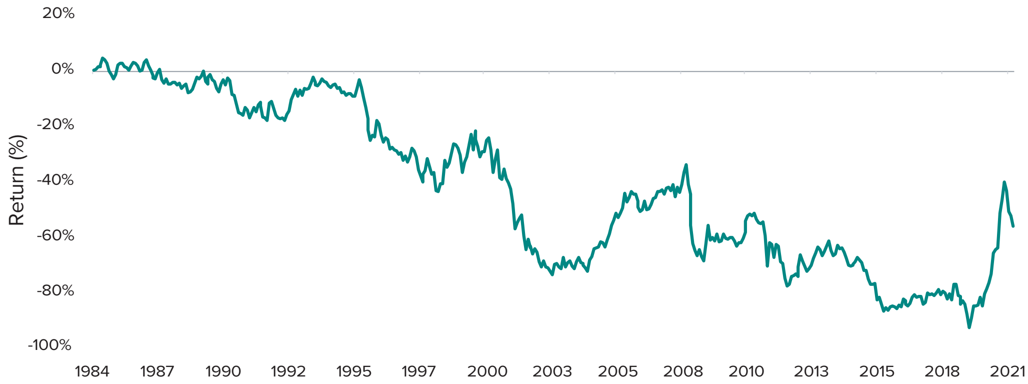
When seeking growth, it is especially hazardous to hunt for "unicorns," a term usually applied to startup firms that have rapidly grown to valuations of $1 billion or greater. The so-called dot-com bubble in 2000 was an exuberant time before the lust for growth destroyed extraordinary amounts of investors' capital.

Relying on the resolve of shareholders to continuously provide new capital for a miniscule chance of success can be particularly risky. Without profits, it is virtually impossible to distinguish true growth from hype. Yet, an enthusiasm for technology companies that is reminiscent of the 2000 dot-com era has taken hold in recent years, fueled by an abundance of cheap capital chasing a limited opportunity with a continual flow of investors' capital pushing the prices of growth stocks higher and higher. This conviction was taken to new levels at the start of the COVID-19 pandemic in 2020. Still, as global economies began returning to normal in 2021, the relative investment returns of growth strategies did the same. In our view, this trend reversal should only strengthen in the years to come.

Big short?

To illustrate the potential danger of unprofitable growth, we constructed a simple experiment. Exhibit 2 reflects a portfolio of Russell 1000 Growth Index constituents (reformed each quarter) with below-market profitability. The historical returns of such a strategy would have been quite attractive for a short seller over the last several decades.

Exhibit 2: Relative Performance of Low-Profitability Growth Stocks



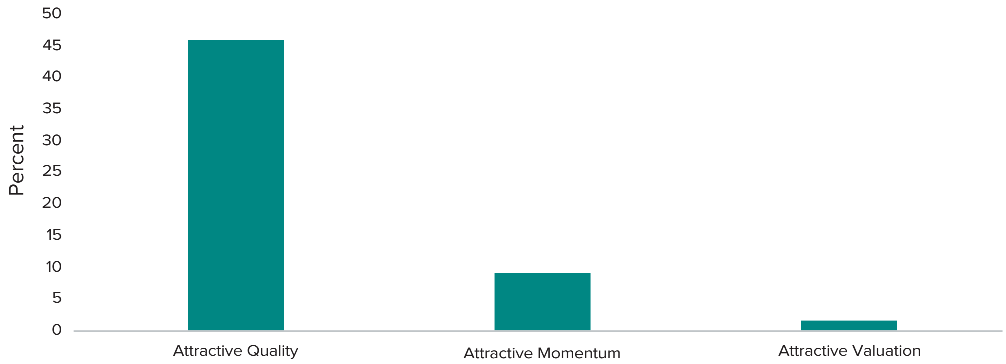
Source: SEI, using data from FactSet, Axioma, and FTSE Russell. Data is for U.S. equities, based from the Russell 1000 Growth Index. The Russell 1000 Growth Index represents the large-cap growth segment of the U.S. equity universe. Low-profitability portfolios are constructed using the bottom one-third of the liquidity-weighted index, grouped by the low-profitability factor style and rebalanced quarterly. The metric is a composite of underlying ratios that SEI has determined to be the appropriate measure of the factor. Factor performance is shown relative to the capitalization-weighted market. Factor and index performance do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Data refer to past performance; past performance is not a reliable indicator of future results. Data spans 12/31/1984-4/30/2021, using SEI's most recent composite methodology.

Good stocks, wrong measurement

Traditional index providers employ simplified metrics to sub-divide the investment universe into "styles." For example, FTSE Russell bases its value-growth split on a stock's relative price-to-book ratio, forecasted medium-term growth, and historical growth in sales-per-share. In other words, stocks that appear expensive on a price-to-book (P/B) ratio and whose companies experienced faster than average sales growth, would be classified into a "growth" index, while others would be classified as "value." However, there is nothing in this metric that measures a company's earnings growth (which is what we believe should matter most to investors) or the quality of such growth.

Many high-quality firms typically end up in either the Russell 1000 Growth Index or the Russell 2000 Growth Index simply because their P/B valuation is above average, regardless of whether they have superior returns on capital (which should in itself justify their inclusion). Numerous studies have shown that P/B is perhaps one of the worst valuation metrics for modern times as there can be challenges with intangible asset accounting, buybacks or historical prices. Indeed, we estimate that approximately half of the Russell 1000 Growth Index today (as of June 30, 2021) are high-quality stocks; the typical growth factor criticisms should not apply to them. Yet, we can't find too many cheaply valued stocks among Russell 1000 Growth Index constituents, and their previously strong momentum has mostly disappeared. Still, as shown in Exhibit 3, there is quality—the kind of quality that generates long-term strategic outperformance and forms one of the strategic pillars of our investment approach.

Exhibit 3: Weight of Russell 1000 Growth Index Constituents by Factor Family

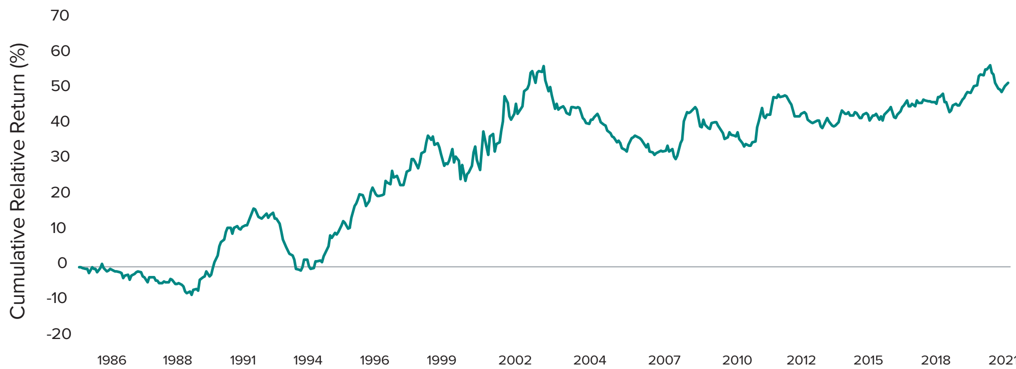


Source: SEI, using data from FactSet, Axioma, and FTSE Russell. Data is for U.S. equities, based from the Russell 1000 Growth Index. The Russell 1000 Growth Index represents the large-cap growth segment of the U.S. equity universe. Each bar represent the top one-third of the liquidity-weighted index, grouped by the respective factor style. The metrics are composites of underlying ratios that SEI has determined to be the appropriate measure of the factor. Data as of 4/30/2021, using SEI's most recent composite methodology.

Our View

Our research shows, perhaps counterintuitively, that company growth alone has not generated excess returns for investors—and that low-profitability growth has not generated historical excess returns. Given this, we would argue that growth-style indexes, with their questionable metrics and two-dimensional views, are of little use to investors seeking to maximize their returns. While we do not broadly view growth as a consistent driver of excess returns, we do like many growth index constituents. Exhibit 4 shows the relative return of quality stocks within the Russell 1000 Growth Index.

Exhibit 4: Relative Return of Quality Stocks within Russell 1000 Growth Index



Source: SEI, using data from FactSet, Axioma, and FTSE Russell. Data is for U.S. equities, based from the Russell 1000 Growth Index. The Russell 1000 Growth Index represents the large-cap growth segment of the U.S. equity universe. Quality portfolios are constructed using the top one-third of the liquidity-weighted index, grouped by the quality factor style and rebalanced quarterly. The metric is a composite of underlying ratios that SEI has determined to be the appropriate measure of the factor. Factor performance is shown relative to the capitalization-weighted market. Factor and index performance do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Data refer to past performance; past performance is not a reliable indicator of future results. Data spans 12/31/1984-4/30/2021, using SEI's most recent composite methodology.

We have said if before, and will say it again: There is no shortcut to long-term investment success. While trendy growth stocks grab headlines (and sometimes generate fast money for speculators), we believe that quality companies make for good investments.

The elevated prices of growth stocks today will likely unwind precisely as they did in the 2000s. To us, in a world of ever-evolving unknown unknowns, diversification appears to be the only prudent solution (as cliché as it may sound). At SEI, in an effort to help investors avoid the kind of loss that was widely inflicted by the tech bubble of the 2000s, we seek to construct portfolios that offer sufficiently broad allocations to stocks, industries and asset classes. As always, when the fashion of the day favors a few, we remain skeptical and look elsewhere.

Glossary

Buybacks occur when a company buys its own shares back to reduce the number of shares outstanding on the open market.

Dot-com bubble refers to a period in the late 1990s characterized by a rapid rise in U.S. technology stock valuations, especially internet-based companies.

Forecasted medium-term growth refers to estimates for company growth anywhere from two to 10 years in the future.

Historical prices are the recorded prices of an asset for a range of dates in the past.

Intangible asset accounting records an asset as a long-term holding and then amortizes the asset over its useful life.

Price-to-book ratio compares the market capitalization of a company to its net assets.

Sales per share is calculated by dividing a company's total revenue by it total shares outstanding.

Index Definitions

Russell 1000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe.

Russell 1000 Value Index measures the performance of the large-cap value segment of the U.S. equity universe.

Russell 2000 Growth Index measures the performance of the small-cap growth segment of the U.S. equity universe.

Important Information

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