U.S. Large Cap Growth

Marketing communication | As of 31 Mar 2025

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- **U.S. large cap growth stocks underperformed in the quarter, with the Russell 1000® Growth Index down nearly 10%. However, we continue to see structural long-term advantages in U.S. large cap growth equities and the relative valuation gap versus other equity classes has returned to normalized levels.**

Market review

In the first three months of the year, U.S. equities pulled back following strong gains in 2024. Volatility spiked after Chinese AI research lab DeepSeek released its model that was purportedly faster and cheaper to produce than its competitors and a mix of economic concerns and policy developments weighed on investor sentiment. Additionally, investors were focused on pending tariff news. Performance of the 'Magnificent 7' (Microsoft, Apple, NVIDIA, Amazon.com, Alphabet, Meta and Tesla) lagged for the quarter as market participation broadened.

U.S. large cap growth stocks underperformed in the quarter, with the Russell 1000® Growth Index down nearly 10%. The pullback follows two exceptional years of returns for growth stocks and the period saw leadership reverse into international and value indexes. We continue to see structural long-term advantages in U.S. large cap growth equities and the relative valuation gap versus other equity classes has returned to normalized levels.

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U.S. Large Cap Growth

Portfolio review

The portfolio outperformed the benchmark for the quarter. The Communication Services, Industrials and Consumer Discretionary sectors were key drivers of relative performance, largely due to stock selection. The Information Technology sector was the largest detractor, primarily due to stock selection. Our voids of the Consumer Staples and Energy sectors also detracted.

Outperformance also reflected the waning influence that we had anticipated of the 'Magnificent 7'. While the group does have some correlation, we believe it is becoming increasingly heterogeneous and are actively managing each position. In aggregate, our active weighting of these holdings contributed to relative performance in the quarter.

Contributors

The top relative contributor to performance for the quarter was global leader in audio streaming and media services **Spotify Technology SA**. The company reported another strong quarter and issued guidance ahead of expectations. The management team has pivoted to focus on profitability, in addition to revenue growth, and the shift has led to higher operating margins and free cash flow generation.

Arthur J. Gallagher & Co, a leading insurance broker for the middle market, announced solid quarterly results, and management reiterated its outlook for continued strong organic growth. The pending closing of its AssuredPartners acquisition is anticipated to secure mid-teens growth in the coming years.

GE Aerospace, a global leader in commercial and defense engines, released earnings ahead of expectations and raised guidance. Highly exposed to aftermarket equipment servicing, the company has benefited from constrained aircraft production and anticipate price increases to lift margins.

O'Reilly Automotive Inc, a leading aftermarket auto parts retailer, beat expectations and raised guidance yet again during the period. The company continues to gain market share and operates in a highly defensive segment of retail. We anticipate any tariff impact to be passed through as price increases given their non-discretionary product category. **Howmet Aerospace Inc** is one of two key suppliers to the aerospace and defense market and reported strong results in the period. While the company is currently benefiting from the aftermarket business, it is also levered to new aircraft production and growth should inflect higher as production ramps at Boeing and Airbus.

Detractors

The top relative detractor was **AppLovin Corp**, a mobile technology company that provides software and AI solutions to help businesses connect with their customers. The company reported strong results during the period and released guidance that appears to be conservative. In addition, the company announced the planned sale of its gaming business which would position the company as a pure-play advertising platform with a higher margin structure as it expands into other verticals. However, the stock detracted from relative performance as several short-seller reports, which management claims are misinformed, were released and higher growth companies faced sentiment headwinds in the period.

Electronic payments provider **Visa Inc** detracted from performance due to our underweight position in the stock; however, the portfolio's aggregated exposure to fintech led to positive relative performance. Visa continues to benefit from the secular shift to digital payments and a reduction in regulations under the new administration could be an additional catalyst.

ServiceNow Inc, a leader in the IT service management software, reported results ahead of expectations during the period yet issued softer than anticipated guidance. We believe that the company will be viewed as a key strategic partner for automation and see increased IT budgets, as well as efforts to drive government efficiency, as a secular tailwind.

Palantir Technologies Inc is an AI application company which enables situational awareness and improves decision speed. The company reported revenue and earnings above consensus in the quarter and issued higher guidance yet detracted from relative performance given investor sentiment towards higher growth stocks. Leading provider of alternative asset management **KKR & Co Inc** beat quarterly estimates yet detracted due to high investor expectations going into the print.

Portfolio positioning

Consistent with our search for AI and innovation beneficiaries, the Information Technology sector remains our largest absolute weight (41% versus 46% in the benchmark); it is also our largest relative underweight. Our largest relative overweight is in the Financials sector (11% versus 8%) where we continue to be overweight secular growers that could benefit from decreased regulation. Our next largest overweights are the Healthcare (10% versus 8%) and Consumer Discretionary (17% versus 15%) sectors as select holdings are focused on the innovation and profit productivity themes. We are underweight the Consumer Staples sector (0% versus 4%) as the growth profiles and valuations of these companies do not meet our investment criteria. The remaining sectors are within 1% of the benchmark and we are void the small Energy, Real Estate and Utilities sectors. From a Growth Type perspective, the Dynamic Growth sector is the largest overweight at 34% versus 30% in the benchmark. Consistent Growth is also overweight at 32% versus 31%. Cyclical Growth at 34% versus 40% remains the largest underweight.

Outlook

The typical New Year enthusiasm fizzled out fast this year for three reasons. First, advances in AI by DeepSeek and cautious commentary from Microsoft spooked the AI-levered stocks. Second, the scale of tariffs may be larger than previously estimated causing a negative short-term rebalancing in the U.S. economy. Third, forced de-risking by multi-strategy hedge funds added to the downside momentum. In a rare occurrence, U.S. indexes underperformed with the S&P 500® down 4.27% and the Russell 1000® Growth down 9.97%. The portfolio outperformed the Russell 1000® Growth Index as the largest weights in the Index underperformed. It was a good relative quarter for select active managers.

There is a lot riding on AI as the future growth and profitability engine of the U.S. growth stock market and in today's digital economy, as the U.S. growth market performs, so goes the overall U.S. market. Our research continues to be very optimistic long-term on the AI theme, but we don't expect a straight-line advancement. Companies that are building AI infrastructure are the early winners and those implementing AI are the long-term winners. The handoff between the two may or may not be seamless. We are enjoying the increased skepticism on AI as that is often the foundation of opportunity.

On the other hand, nobody is enjoying the uncertainty of tariffs. In the short-term, tariffs slow decision-making and are negative for GDP growth. Since we find it difficult to predict the next tariff policy move, we are taking comfort that many of our portfolio companies are largely asset-light businesses; however, most large cap companies have indirect exposure to these impacts. We think the recent correction has taken into account these uncertainties.

Fear is the most powerful emotion in the markets. In recent years that fear has manifested in astounding growth in multi-strategy hedge funds that focus on near-term absolute returns. The most famous are Citadel and Millennium Management. After doubling in size over the last five years, multi-strategy hedge funds, sometimes referred to as "pod shops", have nearly $400 billion under management. Their size dramatically underestimates their influence on markets given their trading time horizon is often measured in days and the use of leverage can be as high as 5x. These hedge funds underwent a dramatic risk reduction selling program in Q1 completely unrelated to fundamentals. The reason for selling is best described by the reported practice at Millennium, if a portfolio team loss reaches 5% of their allotted buying power, the amount of capital the team is allocated typically gets cut in half. When losses reach 7.5%, the positions are liquidated. When the selling started it created additional selling pressure as highly levered and overlapping strategies will magnify losses when the funds exit en masse. When market participants are forced to sell for reasons unrelated to the fundamentals of the business, that is a major opportunity for us. We made some very timely purchases in the quarter.

Finally, there is some excitement about an improving European outlook as both the Euro and European stocks outperformed. While there is no change in the secular challenges of declining demographics, excessive transfer payments and lack of new business formation capital, there is hope for a short-term improvement from deficit spending on infrastructure, including defense. While we are hopeful Europe can once again contribute to global growth, we remain very cautious as their choice of deficit spending has a very low multiplier impact (nostalgia alert: The Guns (national defense) vs Butter (commercial programs) model from high school economics). Europe won the quarter from a performance perspective, but we remain convinced that they have no chance of winning the long-term performance game.

Index Thoughts

March brought the first of the new quarterly rebalances from FTSE Russell ("Russell") to keep the Russell 1000® Growth Index in compliance with the 25/5/50 U.S. Regulated Investment Company IRS capping thresholds. In summary, they reduced weight in the Magnificent 6 ('Mag 6') by 1.4% and distributed the weight to the rest of the Index. What is less well understood is how close the Index was to a substantial weight down of the Mag 6 and how this could happen in the June rebalance. Russell sums the top five stocks in the Index and if they are below 45% in aggregate weight, they will then include the next stock, provided it is over 4.5%, to sum the weight. The next stock is Meta, which was just reweighted down to 4.50% in the March rebalance and lowered to 4.26% as of the end of the quarter. If Meta stock breaches 4.5% and the remaining top five stocks stay below 45%, then it is possible the Mag 6 could be reweighted lower by 4.5% in the June rebalance. If Meta stays below 4.5% by June there may not be a rebalance.

The Russell 1000® Growth Index is a very rigid Index that has seen little subjective oversight like the Nasdaq Composite and S&P 500® Indexes. This has led to some strange dynamics like the Russell 1000® Growth Index having 394 stocks versus the Russell 1000® Value having 870 stocks as of the end of the quarter. It has also seen substantial changes year to year where META moves to the value index for twelve months and then back to the growth index. Another strange dynamic was the reweighting higher of the Mag 6 for the previous five years by 6.5% unrelated to price performance, which is now being unwound due to the 25/5/50 rule. With such abrupt changes and excessive concentration, the Russell 1000® Growth Index has distorted manager performance benchmarking and unnecessarily driven higher turnover for market participants. We remain highly critical of Russell and, while it will remain our primary benchmark, we advise investors to use peer ranking and the S&P 500® as a supplemental index to assess manager skill.

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Glossary

Free cash flow is a measure of financial performance calculated as operating cash flow minus capital expenditures. Free cash flow (FCF) represents the cash that a company is able to generate after laying out the money required to maintain or expand its asset base. Free cash flow is important because it allows a company to pursue opportunities that enhance shareholder value. Without cash, it's tough to develop new products, make acquisitions, pay dividends and reduce debt. **Inflation** is a rise in the prices of goods and services, often equated with loss of purchasing power. **Valuation** is the process of determining the current worth of an asset or a company; there are many techniques used to determine value. An analyst placing a value on a company looks at thecompany'smanagement, thecomposition of itscapitalstructure, the prospectof futureearnings and market value of assets. The **Russell 1000® Value Index** measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. The **Russell 2000® Growth Index** measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. The **S&P 500® Index** is widely regarded asthe best single gauge of large-cap U.S. equities. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

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