

## U.S. Large Cap Growth

Marketing communication | As of 30 Sep 2024

- **Financial markets anticipated Fed action and small cap and value stocks won the quarter. The Russell 2000® Index and Russell 1000® Value Index both returned over 9% in the third quarter. International stocks, as measured by the MSCI EAFE Index, were up over 7% and the Russell 1000® Growth Index posted a gain of over 3%.**
- **In a stark contrast to recent quarters, the 'Magnificent 7' was up only 1%. Year-to-date, however, growth equity leadership has sustained with the Russell 1000® Growth Index posting returns of over 24% and the S&P 500® over 22%, well ahead of most other major equity indices.**

### Market review

All equity markets rose in the quarter due to the anticipation and ultimate lowering of interest rates by the Federal Reserve. Market leadership shifted away from the 'Magnificent 7' (Microsoft, Apple, NVIDIA, Amazon.com, Alphabet, Meta and Tesla) and broadened significantly; the equal-weighted S&P 500® posted its best third quarter since 2010. Despite rising geopolitical concerns and upcoming elections, the quarter ended with tailwinds including rate cuts and positive news from China.

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## Portfolio review

The portfolio's positive return trailed the Index for the quarter. Strong stock selection in the Communication Services sector and our overweighting of the Industrials sector were key contributors to relative performance. Stock selection in the Financials sector also aided performance. Stock selection in the Information Technology, Consumer Discretionary and Industrials sectors were the largest detractors.

Year-to-date, the portfolio's robust return is in line on a gross basis and slightly trailing the Index on a net basis. Strong stock selection in the Consumer Discretionary and Communication Services sectors were key contributors for the period as was the weighting and stock selection in the Consumer Staples sector. Stock selection in the Information Technology and Materials sectors were the key detractors for the period. The Energy and Utilities sectors modestly detracted.

## Contributors

The top relative contributor to performance for the period was **Fair Isaac Corp**, a key provider of predictive analytics and services for consumer credit worthiness. The company has a strong competitive moat, high barriers to entry and pricing power. Management has executed well on its strategy and we continue to model upside to both pricing and volumes.

**MercadoLibre Inc**, the leading e-commerce and emerging fintech player in Latin and South America, also contributed. E-commerce growth in their markets continues to be higher than other regions due to lower penetration levels. The company has been gaining market share in e-commerce due to distribution network expansion and on the fintech business by leveraging their e-commerce client relationships. In addition, quarterly results were well above expectations.

Asset manager **KKR & Co Inc** reported strong revenues and fundraising activity. Streaming service provider **Spotify Technology SA** has pivoted to focus on profitability, in addition to revenue growth, and the change has led to higher operating margins and free cash flow generation. Residential and commercial HVAC system provider **Trane Technologies PLC** also contributed after reporting another quarter of strong results and raising guidance.

## Detractors

**Edwards Lifesciences Corp** detracted after missing revenue expectations; increased competition weighed on the

company's transcatheter aortic valve replacement device sales. The position was sold.

Leading provider of etch semiconductor capital equipment **Lam Research Corp** detracted after the company's earnings report failed to meet high expectations for the company's memory chip equipment and after some uncertainty about chip makers' capital spending budgets.

We initiated a position in electric vehicle leader **Tesla Inc** as we anticipate future catalysts to include positive production inflection, a model refresh, embracing of financing initiatives, full self-driving enhancements and the Robotaxi opportunity. The holding detracted from performance given our underweight position. Our underweighting of **Apple Inc** also detracted as the market anticipated a cyclical uptick in smartphone sales due to new AI features. Although a large position in the portfolio, we remain below the 12% benchmark weight preferring other higher growth technology holdings. Semiconductor equipment leader **ASML Holding NV** reported a solid quarter yet detracted on concerns that the U.S. government may restrict sales of the company's equipment to China. However, recent press reports now suggest the Netherlands will be excluded from upcoming export control regulations.

## Portfolio positioning

Consistent with our search for innovation beneficiaries, the Information Technology sector remains our largest absolute weight (47% versus 49% in the benchmark). We increased our exposure to the Consumer Discretionary sector (17% versus 14%) as select holdings in this sector are also focused on profit productivity. Our largest relative overweight is in the Industrials sector (8% versus 5%) where we continue to be overweight secularly growing industries such as aerospace, electrification and commercial HVAC. Communication Services (14% versus 13%) is also overweight due to the productivity theme. Our largest relative underweight is the Consumer Staples sector (0% versus 4%) as the growth profiles and valuations of these companies do not meet our investment criteria. The Financials sector (4% versus 6%) is also underweight. The Materials (1% versus 1%) and Healthcare sectors (8% versus 8%) are roughly equal weight 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 35% versus 29% in the benchmark. Cyclical Growth at 37% versus 41% remains the largest underweight and Consistent Growth is also underweighted at 28% versus 30%.

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## Outlook

We believe investors should be comforted by the Fed's courage to step up with a 50 bps cut to the Fed Funds rate, as it signals their comfort with the inflation outlook and a real time understanding of weakening economic growth. But reading between the lines, the message is that the "Fed put" has returned as they work to normalize the Fed Funds rate back to 3% with plenty of firepower from there. With the grand experiment of zero interest rate policy fading into history, we believe the monetary system is on firmer footing.

With the Fed at the ready and a soft landing more likely, the stock market has broadened out beyond the 'Magnificent 7.' We view this as a healthy and welcome development. Yet investors should remain balanced as the excitement builds for potential new leadership. We model that while the growth premium of the 'Magnificent 7' looks to narrow compared to the rest of the market, it still holds a notable premium. And compounding of per share growth over time drives stock prices more than short-term changes in valuation.

What is not yet fully realized is how early we are in a new cycle of what we call "Profit Productivity." Profit Productivity is not just how much economic output can be produced per hour worked, but how much profit can be generated. We believe a new cycle of Profit Productivity will be driven by 1) the deployment of Generative AI and 2) an executive mindset shift, not yet fully understood, among

leading growth companies to harvesting profits rather than building scale. This is bullish for stocks as they are, of course, fractional ownership in profits. And we believe large cap growth stocks will be the greatest beneficiaries of this new cycle as they have the most harvestable business models.

Generative AI is beginning to drive major efficiency in software development, customer care and back-office processing. Based on our discussions with managements, we believe that companies with AI projects are shifting timelines from years into months based on the productivity they forecast.

The executive mindset shift at growth companies is happening one company at a time, but the theme is spreading fast. Select companies are moving from losing money to generating billions in profits. Others have driven eye popping increases in profit margins. The sentiment appears contagious and we expect others to follow.

This new productivity cycle is particularly timely as neither of the two Presidential candidates have prioritized fiscal responsibility in their economic agendas. Given the low unemployment rate, slow rate of working-age population growth and deficit spending, a period of higher productivity is needed to keep inflation contained.

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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 the company's management, the composition of its capital structure, the prospect of future earnings 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 as the 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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