GROWTH AND LOW RISK: A HARMONIOUS COEXISTENCE?

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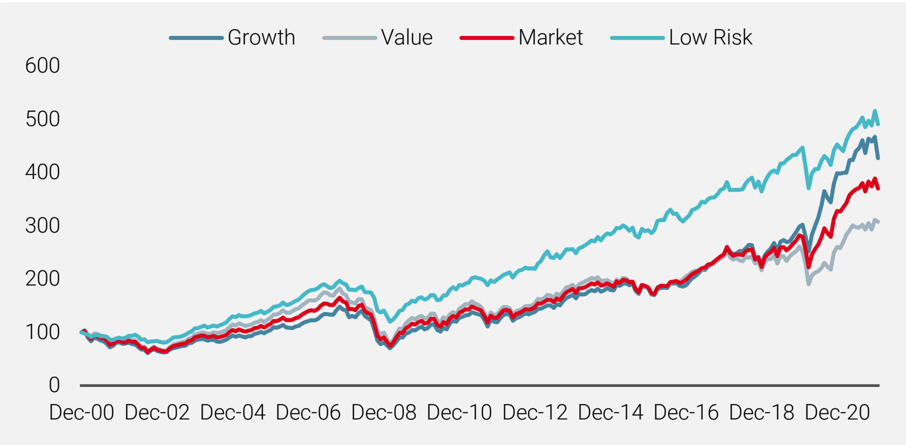
A Regime Shift

Growth investing is a well-known strategy in active management. The aim is to put together a portfolio of stocks that captures higher than average growth rates in share prices, profits, revenues or cash flows. The growth style has outperformed many others styles over the past decade, notably enjoying strong outperformance versus value, as demonstrated in Figure 1, and this despite the long run value premium. The relative attractiveness of growth stocks depends on many factors such as their perceived opportunities for financing and expansion, their borrowing costs, cash flows, profits and so on. Therefore, changes in interest rates, economic growth and market sentiment are all factors that can affect how they perform relative to value stocks.

Figure 1: Long Term Style Premium



Source: Bloomberg, MSCI and Unigestion. Data as at 31 January 2022.
Reading note: MSCI ACWI Net TR USD Index is used to represent market portfolio, MSCI ACWI Growth Net TR USD Index is used to represent Growth, MSCI ACWI Value Net TR USD Index is used to represent Value and MSCI ACWI Minimum Volatility Net TR USD Index in used to represent Low Risk.

Since March 2020, the Covid pandemic has amplified the demand for technology and related services, resulting in a surge in growth stocks (especially technology stocks). Specifically, we saw an increase in the need for online shopping, distance learning and home working – so much so that broadband, video conferencing, streaming, gaming and e-commerce are now seen as essential services. In developed markets, investors were particularly drawn to high-growth names such as the FAAMGs (Facebook, Amazon, Apple, Microsoft and Alphabet's Google), while in emerging markets, e-commerce and internet technology stocks were the main attraction (e.g. Tencent, Alibaba, Meituan). Vaccine makers were also sought after, as there was pretty much no growth in other areas of the markets.

However, now, betting everything on growth stocks continuing to outperform, particularly when valuations are already so high, is not without risks. Growth stocks, reasonably long-duration assets, tend to benefit in a low-interest-rate environment and have enjoyed a fantastic run since the global financial crisis (GFC). However, with Federal Reserve tapering looming, it will be interesting to see how things develop.

Key Points

1. Growth stocks have strongly outperformed other styles over the last decade.
2. However, in the current market context, betting on their continued outperformance is not without risk.
3. Despite the distinctive approaches of growth and low risk, they can complement each other in a broader equity asset allocation.

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After a spectacular run when vaccines were first announced toward the end of 2020, vaccine manufacturers have lost some of their sheen and sparkle in recent months. Moderna is a case in point, following the release of an underwhelming earnings report and lacklustre sales expectations for its vaccine products for the remainder of the year.

Then, just as investors were grappling with uncertainty over whether billions of dollars in sales would materialise as global economies reopen and other therapies are developed, the discovery of the Omicron coronavirus variant late last year reversed sentiment and markets dramatically, and volatility picked up sharply. To illustrate the point, Tesla's outsized fluctuations make it among the most volatile of the US mega caps in recent months, its share price further impacted by stock sales by its founder and CEO, Elon Musk. After hitting a trillion dollar valuation last October and quickly peaking at more than USD 1.2 trillion, the company is now worth "only" USD 900bn after a 27.5% fall in its share price year-to-date (as at 28.02.2022). Investors may like many things about Tesla, but volatility is certainly not one of them.

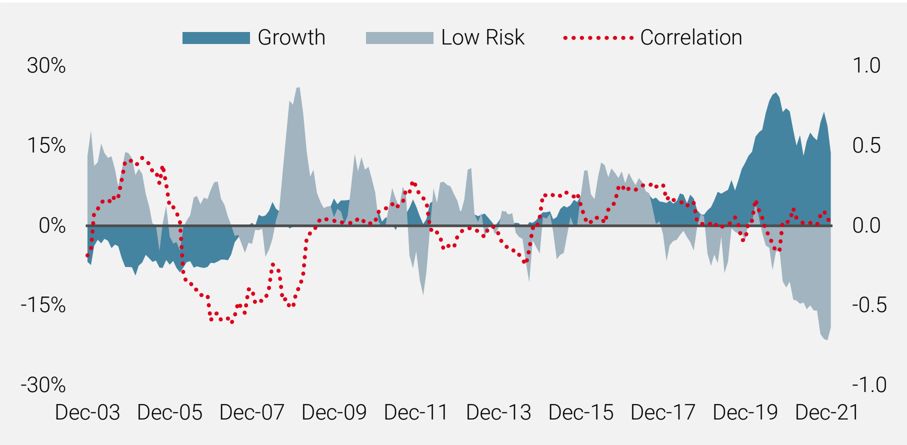
Moving into January 2022, shares in Peloton, a fitness company best known for its exercise bikes and remote classes, crashed after the company cut its annual revenue forecast and announced a temporarily halt in the production of its bikes and treadmills. Unlike during the peak of the pandemic period, the company's current supply output is meaningfully outpacing demand. So far in 2022, other once high flying mega tech growth stocks have also corrected sharply lower, with the likes of Netflix (-34.0%), Facebook parent Meta (-37.7%), Twitter (-16.7%) and Zoom (-28.0%) all suffering massive hits. (Prices as at 28.02.2022).

Conversely, low risk stocks might be considered as "boring" companies that typically do not make for "media darlings". Moreover, due to often high recurring revenues and pricing power, there tends to be little variation in quarter-to-quarter or year-to-year growth. An example would be Novo Nordisk, where sales are driven by its robust diabetes products. However, its growth outlook is also encouraging and one of the strongest in the sector, given the potential product growth opportunities for Alzheimer's disease.

Harmonious Coexistence

Despite the distinctive characteristics of growth and low risk, they can complement each other in a broader equity asset allocation. The low or negative return correlations often observed between the two styles have historically helped diversify some of the short-term risk and, as a result, the combination of both strategies in a single portfolio has often delivered smoother performance.

Figure 2: Long Term Style Premium



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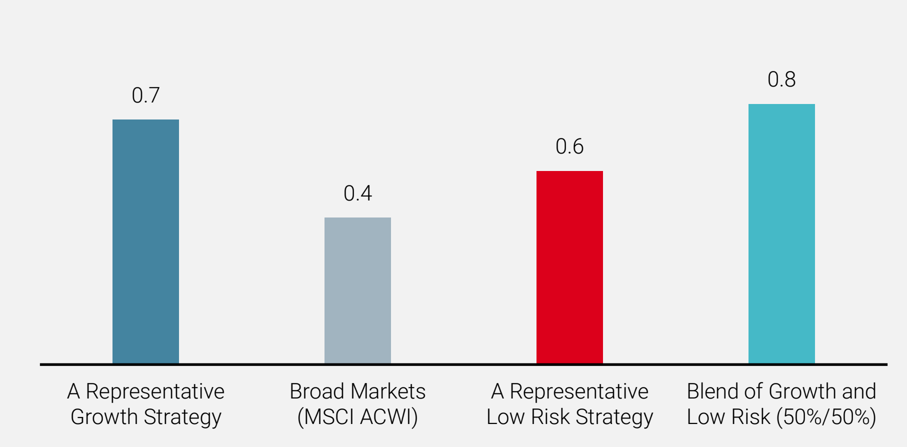
To quantify the effect of employing a low risk equity strategy alongside a growth strategy, we created a hypothetical portfolio plan that consists of two representative strategies at 50% each. As shown in Figure 3, such a balanced approach can deliver superior risk-adjusted returns.

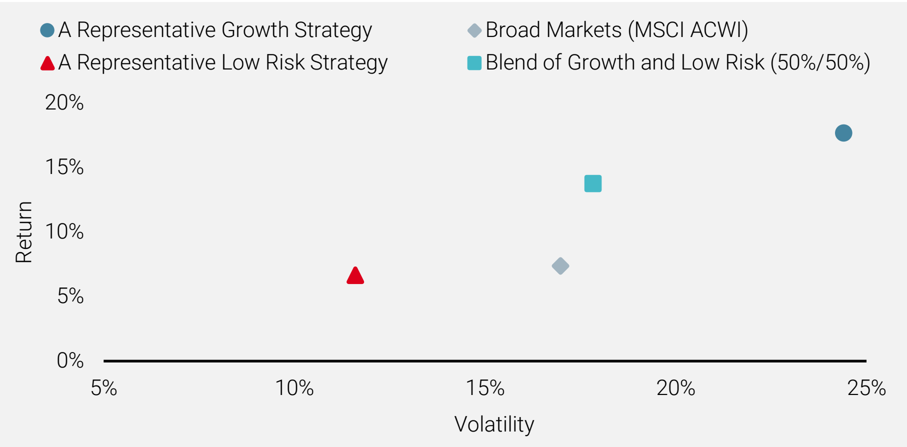
Figure 3: Risk-Adjusted Performance – Sharpe Ratio



Source: Bloomberg, MSCI and Unigestion. Data as at 31January 2022.

Furthermore, as Figure 4 illustrates, this combination delivered a meaningful risk reduction of around 30% while maintaining a high growth rate of 15%. It has certainly helped enhance the return profile of a standalone low risk strategy.

Figure 4: Impact of De-risking with a Low Risk Equity Strategy



Source: Bloomberg, MSCI and Unigestion. Data as at 31January 2022.

The Fed and other central banks have played their cards, and investors are already pricing in a series of interest rate hikes. In the event that they increase faster than expected, it is far from clear whether high growth stocks will continue to outperform low volatility stocks, as applying higher rates to future earnings may well hurt long-duration stocks. However, as we have clearly demonstrated, both growth and low risk stocks can play an important role in the diversified portfolios of long-term investors.

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