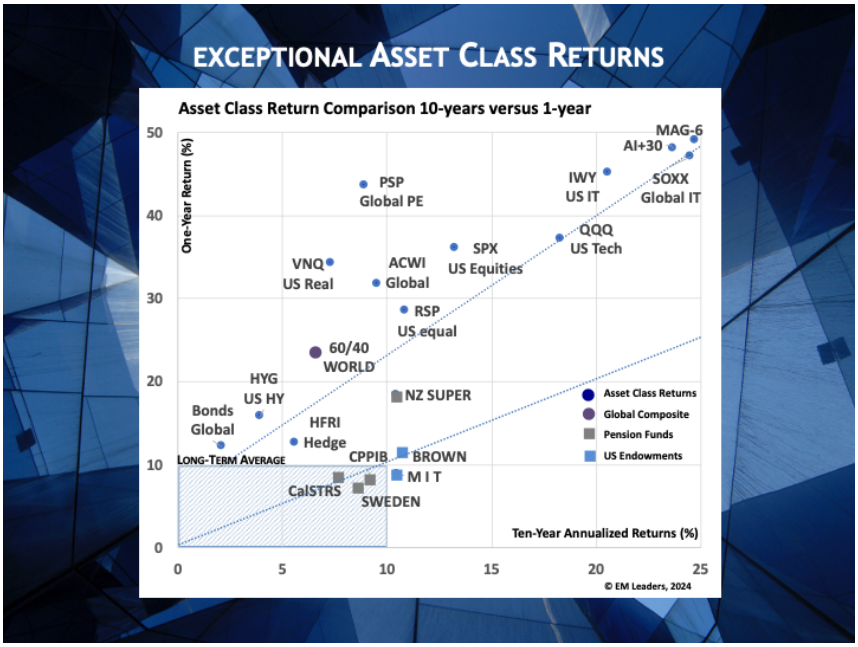


GROWTH INVESTING AT REASONABLE VALUATIONS
HOW TO NAVIGATE BEYOND A TOP-HEAVY OVERVALUED US EQUITY MARKET

Q1> What is SPX expected 10-year return versus its current average? 3% versus 13%
Q2> Which asset classes are most versus least overvalued? US mega-cap versus Asia
Q3> How to compare 32 AI-driven growth compounders? PEG range 1(TSM) to 8(TSLA)

Market expectations today are disconnected from realistic long-term returns. Warren Buffet achieved an 11% annual return with Berkshire Hathaway over the past decade. Cathy Wood delivered 10% annual returns for a decade with her ARK innovation fund. Yet, over the past year alone, the Magnificent seven growth stocks returned 60% and ten-year annual returns for global semiconductor stocks SOXX have now reached 25%. That puts the US CAPE at 37 or the top two percentile, versus 19 for non-US equities.

How unusual are market returns this year?

Comparing one-year versus ten-year annualized returns (chart 1) reveals that ACWI global equities returned an average 10% over the past decade versus 32% last year. Global bonds returned an average 2% over ten years as compared to 12% last year. A key driver for the exceptionally high returns over the past year is the broader US technology QQQ fund, which returned 18% over a decade versus 38% over 12m. All the longer-term aggregate returns have been pushed higher by very strong recent returns.

What would mean reversion suggest for the S&P500?

Annual returns for the S&P500 have historically averaged 13% with a 15% standard deviation, meaning ten-year returns have fluctuated between -5% and +21% depending on the starting point and relative valuations. Goldman Sachs is now predicting that ten-year returns for the SPX over the next decade will likely decline to a nominal 3%. The anticipated correction is expected to be most pronounced for the largest stocks, and the equally weighted RSP is likely to outperform the SPX by about 5%.

BAML is offering a similar prediction that the SPX is likely to offer meagre 2% nominal returns on average over the next decade, as compared to 5% for the equally weighted RSP, offsetting a 3% mega-cap premium that was accumulated over the past decade. Overvaluations as expressed by CAPE ratios for US equities accelerated this past year after the S&P top7 MAGS added 65%, the SPX advanced by 38% and the RSP by 32%.

Q1> The extended cycle of outperformance for US equities, esp. large-cap stocks and the Mag7, is likely to end with much lower equity returns for the next decade.

How are benchmarks adjusting for leading long-term investors?

Top quartile US endowments, such as MIT and Brown, recently announced their results with ten-year annualized returns of 10.5%, exceeding ACWI global equity returns. And top-quartile pension plans in New Zealand (NZ Super 10.4%), Canada (CPPIB 9.2%), and Sweden (AP3 8.7%) delivered solid returns that all exceed the 60:40 world benchmark. Even CalSTRS announced a respectable 7.7% average ten-year performance, beating its 7% benchmark, although its funding level remains below 80%. Hence, 8% to 10% nominal annual returns have been considered excellent for long-term investors.

Which factors differentiate successful long-term investors?

Governance is the overarching theme that has been most important, even beyond asset allocation. The Maple model shows steady improvements from an independent board and market-paid investment professionals. Partnering with leading global investment firms has initially added to fees but yielded long-term benefits from training internal staff and enhancing top quartile returns. Long-term performance incentives have also helped to align interests with those of stakeholders. A strong risk culture has been critical to reduce drawdowns and enhance steady long-term returns.

Which asset allocation themes have become more common?

Many long-term investors have reduced allocations to fixed-income (even to single digits for some endowments) and increased allocations to credit and alternatives, especially private credit, where spreads have reached historic lows. Moreover, some investors have aggressively shifted from public into private equities (esp. in the US "endowment model"). Home-bias has been gradually reduced for most investors but remains large for some US-based institutions. Thematic investing with a focus on growth themes (mostly by sector, not geography) has become more pronounced.

Where are asset classes currently in their cycles?

The fixed-income cycle bottomed in 2022 with the rapid increase in interest rates which was followed by a bottoming in US real estate in 2023. Private equity also had a poor vintage in 2023 with negative returns for venture capital. Commodities, infrastructure, and hedge funds have only had modest returns and offered limited diversification during mid-cycle. Public equities, especially US large-cap stocks, reached their late-stage cycle, but many EM equities are still in early-cycle. Both the US dollar and the US business cycle are now in extended late stages.

Q2> The endowment model was successful during mid-cycle but is now strained by corrections in alternatives and overvaluations of US mega-cap equities.

How can growth-investing still outperform in these markets?

Growth investing is an investment strategy focusing on companies that are growing faster than the market average, often smaller and younger companies that expand profitability in new products across sectors and across geographies. It does include the magnificent seven US mega-caps as well as private equity investments into US start-ups such as OpenAI. Artificial intelligence has become a driving factor in many listed companies in the Americas, Europe, and Asia. Trade tensions and nationalism could further strengthen moats of regional leaders in each of the growth industries. Higher AI-driven growth and modest valuations are both critical for future success.

What are the eight most promising AI-driven growth segments?

Six of the magnificent seven stocks dominate four AI segments: Nvidia and AMD are most successful in **core AI hardware**, Apple and Microsoft dominate the **software** segment, Google and Meta are expanding the **cloud and cyber** business, whereas Amazon and Shopify have realized great returns in **e-commerce**. But there are four additional segments where applied AI has major implications: **Genomics** can benefit tremendously, **Space & robotics** already receive strong military interest, the **Energy transition** extends into batteries, autonomous driving, and new nuclear technologies, and finally **Financial Aggregators** (such as KKR and Brookfield) offer investors access to most promising private equity portfolios with focus on growth and innovation.

Which firms have a ten-year compounding record on growth investments?

Investors may find external managers which are specialized in a particular segment or geography and/or may build an internal equities book with convictions across these eight AI growth segments. It would be ideal to identify high-growth companies with growing earnings and a ten-year track record with annualized returns of 15% to 25% (compounders). Chart 2 reveals four leading large-cap companies in each segment from the current Mag7 (orange), North America (yellow), Europe (blue) and emerging markets (green). Excluding the two most expensive firms (Nvidia and AML), the 30-stock portfolio would have returned 24% annualized with a current median P/E of 38.

How do growth segments compare across geographies?

All eight growth segments would have achieved impressive returns above 20% CAGR over the past decade. Returns for Europe would have been 19% versus 23% for EM and over 30% in the US although valuations of US growth firms are currently about twice as high as those of European and EM growth firms. As expected, valuations are most extended in AI software and most reasonable in financial aggregators, more attractive in emerging markets and in mid-cap companies. Most impressive recent growth in genomics occurred in Asia, while European firms appear strongest in the RE-transition.

Which growth companies are still valued attractively?

Valuations for growth companies depend on estimates for future growth (next five years) which are then compared to current multiples (price to next year's earnings). The PEG ratio (price to earnings growth) is measuring the P/E multiple for each unit of additional earnings growth. Chart 3 illustrates our set of 32 compounders across eight AI-driven categories with PEG ratios ranging from one (TSM) to eight (TSLA).

The dotted line illustrates the average PEG ratios ranging from modest growth (left) to rapid growth (right), with attractive valuations above the line and overvalued firms below the line. Median values for these growth stocks (versus SPX) reveal forward P/E ratios of 36 (versus 23) driven by expected median earnings growth of 18% (versus 5%). LMT is similar to the SPX valuation and expected growth (least attractive datapoint).

Where is best relative value across growth categories?

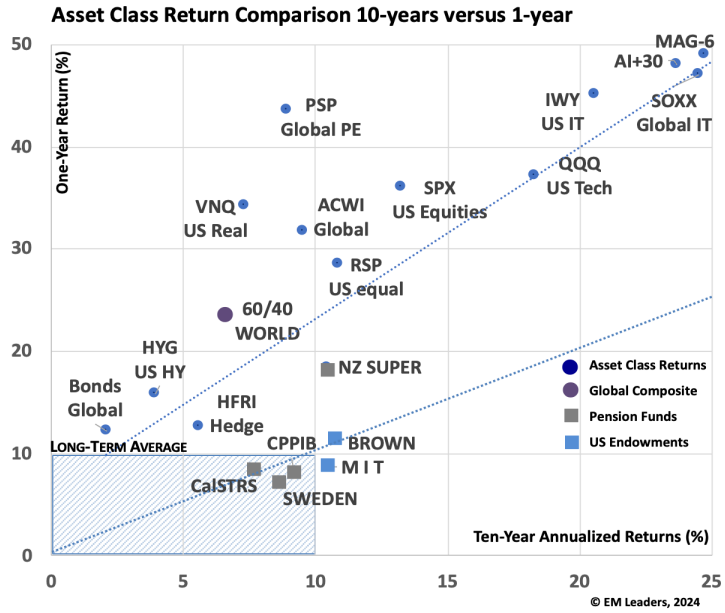
Our sample of 16-firms above the line has a median PEG=1.5 and 12m returns of 80%, compared to our below-the line group with PEG=3.0 and 12m returns of 40%. Firms in EM have estimated growth rates of 25% versus 13% for European firms. P/E valuations for firms in finance (22) and cyber-cloud business (24) are more attractive than those in software (38) and e-commerce (40). Some relative-value pairs are standing out: TSM > ASML; NOW > SAP; MercadoLibre > Amazon; TDG > LMT; BYD >Tesla; KKR > BN.

Q3> Innovation from AI is spreading to multiple growth segments globally, well beyond the Mag7, and investors may capture more diverse sources of alpha. Expected returns are higher for lower PEG ratios (above the line in chart 3).

In summary, growth investing has been very rewarding over longer periods but can face significant volatility during market downturns. Current US equity market returns are extraordinary and cannot be sustained. Substantial home bias to US markets with very high valuations can be mitigated by including additional innovation segments with strong performers in Europe and in Asia. Financial aggregators offer access to their portfolios of innovative private companies as an alternative to co-investing with leading private equity platforms. Anticipated lower overall equity market returns make it imperative to identify new strategies to capture alpha from growth markets. Compounders with more reasonable PEG valuations still carry a lot of promise.

http://www.emleaders.com/pdf/EML-Growth-2024.pdf

Asset Class Returns 10-vs-1 year Chart 1



AI Innovation Segment Returns — Chart 2

AI Innovation Segments and Annualized Returns (10-years)

AI-Hardware 45	AI-Software 25	Cloud-Cyber 23	E-Commerce 34
Nvidia 79	Apple 26	Alphabet 20	Amazon 28
AdvMicro 50	Microsoft 27	Meta23	Shopify 43
ASML 24	ServiceNow 32	Gen Digital 37	MerLibre 34
TSMC 26	SAP 14	Check Point 12	Globant 32
BioTec Genomics 26	**Space Robotics 21**	**E-Transition 22**	**Fin-Aggregators 22**
Eli Lilly 33	TransDigm 28	Tesla 30	KKR 24
Novo Nordisk 20	Lockheed Martin 17	Eaton 23	Brookfield 26
Samsung Bio 21	Safran 16	Schneider 18	Partners 23
Beigene 29	Hindustan Aero 23	BYD 19	ICICI Bank 13
MAG7 33	**USA8 31**	**EUR8 19**	**EME9 23**

Growth Valuations of Leaders — Chart 3

Valuation of Growth Compounders (Multiples per Growth)