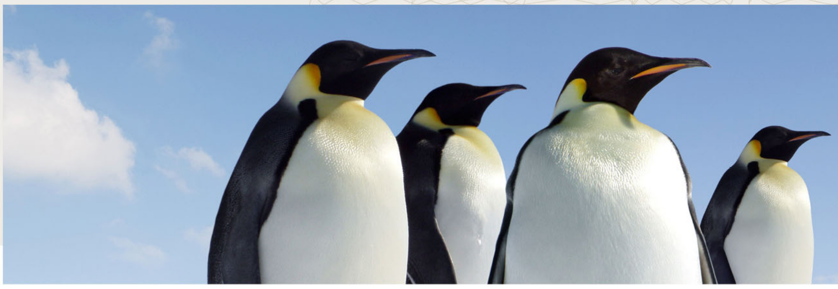



# Growth Finally Comes at a Reasonable Price

The years following the covid pandemic can be described as "unprecedented" due to the significant amount of volatility, both to the upside and the downside in the markets. Growth stocks, in particular, were pushed to stratospheric levels only to halve and halve again, with many shares dropping by more than 80% from their all-time highs. Inflation has spiked to levels last seen 40 years ago, forcing central banks around the world to aggressively raise interest rates to contain inflationary pressures.

**TINA TO TARA**

The term TINA, *there is no alternative*, has been widely used by market participants in financial markets where a combination of central bank quantitative easing (QE) and an artificially low-interest rate environment supported buying virtually any shares that showed growth, even if those companies were unprofitable. This term has quickly/since changed to TARA, *there are reasonable alternatives*.

As interest rates and bond yields have risen substantially in the face of rising central bank rates, investors' opportunity set for earning a reasonable yield has grown. Higher interest rates mean that investors now have access to more assets that generate reasonable returns, with potentially lower levels of risk than equities.

At the same time, higher rates increase the discount rates that are used in the valuation of assets, such as equities. The assets that are the most impacted and susceptible to this are long-duration assets like growth shares.

Rising interest rates are not the only headwind to pressure the valuations of growth shares. Slowing economic growth and recession fears have also dampened the general growth outlook, leading to depressed valuations, particularly for high-growth shares whose valuations are tied to their ability to grow top-line revenue into the future.

**Markets move further than expected on the way up and on the way down**

The headwinds impacting stock markets have meant the Nasdaq Index, which is typically representative of high-growth tech companies, has fallen by 35%. The Nasdaq Index is in deep bear market territory, but the mega-cap technology stocks have masked the true carnage that has occurred for smaller and mid-sized companies within the index. The ARK Innovation Fund (ARKK) is probably the best-known actively managed

Exchange Traded Fund (ETF) that invests in high-growth companies, with its founder Cathie Wood ever present in the media. To illustrate the exuberance of the market chasing growth shares, ARKK rallied by over 380% from its March 2020 lows only to fall by nearly 80% from its previous all-time highs. At the same time, cloud stocks were 61% off their peak, fintech stocks were 63% off their peak and e-commerce stocks also collapsed by 63%.

At the extremes, investors and traders alike could not get enough of growth shares that were set to benefit from the accelerated adoption of technologies, buying up companies at valuations not seen since the dot-com bubble. In many cases, unprofitable tech companies were trading at 30x price to sales (P/S) ratio and even profitable growth companies traded at price to earnings (P/E) ratios of over 60. The P/E ratio tells investors how much they are paying per unit of earnings the company produces. The market average ranges between 15-25 times, so a PE above this is considered expensive, while a lower PE ratio is considered to represent better value.

As these shares continued to rise, the likelihood of positive future returns diminished dramatically. At the end of the bull market, the prices paid by investors, despite positive growth prospects on the way up, made absolutely no rational sense and led to significant wealth destruction for those who bought at the time.

Bear markets are painful but fortunes are made in bear markets and not bull markets. This is because assets can be purchased at highly depressed valuations relative to their potential. Across most sentiment indicators, the investment mood is uniformly negative, but this has provided investors and particularly growth investors with an opportunity to buy quality growth shares at reasonable valuations again at levels well below their 2019 pre-covid levels.

**From growth abundance to growth scarcity**

The differences between the current market conditions and the conditions that sparked the stock market rally in 2020/2021 are vastly different. Then market liquidity was high, sentiment positive and growth abundant. The environment has now switched, and growth has become a scarce but sought-after commodity.

Current negativity towards growth shares is typical of the short-termism that dominates financial markets and provides an opportunity for investors with a longer-term perspective. At this point, investors need to determine which companies have sustainable business models that are growing despite the macroeconomic headwinds and that can compound investor returns over many years. The distinction between structural growth companies and momentum growth companies is important, especially in the current environment, as momentum growth typically ends abruptly. A great example of a momentum growth company is Zoom, the video meeting software that became commonly used during covid. Zoom is a good company and received a big boost from covid. However, Zoom does not have a real competitive advantage, nor any type of moat, and its growth momentum is unlikely to be sustainable.

**"You can't predict. You can prepare." – Howard Marks**

Timing the markets is an extremely difficult task. However, investors can be prepared and invest in quality growth companies, particularly in a time such as now when they trade at valuations closer to the lower end of their historical bands. This will transpire once inflation is seen to have peaked and begins to subside and the aggressive monetary policies of global central banks fade.

**Structural Growth on Sale**

There are a variety of sectors that benefit from structural tailwinds supported by secular trends. These sectors include software, fintech, blockchain, wellness, clean energy, electric vehicles, agri-tech, biotech, luxury goods, medical devices and semiconductors. The key within these sectors is to determine which companies are best placed to benefit from these trends and whether they can be bought at reasonable prices that justify their future prospects with a reasonable level of confidence.

We see potential across the size and risk spectrum of growth companies at present. On the large market-cap front, Adobe (ADBE) stands out as a high-quality growth company trading at an attractive valuation when compared to its history. Adobe is the quintessential Software as a Service (SaaS) company, with products that are critical to the digital age. Booking.com (BKNG) is also trading at a reasonable valuation and stands to benefit from the travel spending boom that has emerged post covid.

Within the luxury goods sector, Canada Goose (GOOS) offers a good combination of value, quality and growth. Demand is resilient for luxury goods and Canada Goose's famous parka jackets remain in high demand across existing and new growing markets. The renowned quality of their products, coupled with the launch of new categories such as shoes and accessories, provide a strong growth underpin.

One sector that remains recession-proof is the cybersecurity sector. The intensity, sophistication and frequency of cybercrime and cyber-attacks continue to grow steadily. The companies that operate in this sector need to have cybersecurity technology solutions that are ahead of their peers. Those that are technologically superior will continue to grow at an attractive pace as customers continue to deploy capital to keep their businesses and their customers protected. Crowdstrike (CRWD) is a great example of a high-growth company that has technological superiority within a growing theme.

Another sector that has incredible potential is Biotech, particularly biotech companies in areas like genomics, and at current prices they make for an attractive investment proposition. The dynamics of the industry look to biotech companies to raise capital for research and the development of new treatments and therapies. As these treatments move from development and closer to product approval these companies become more valuable and are either bought out by larger pharmaceutical companies, or they monetise their new treatments. This sector is trading close to its cash levels, meaning investors can buy these companies at the same value as their cash holdings and essentially own their intellectual property for free. Given the high-risk nature of investing in individual biotech shares, we take advantage of these dynamics by investing in the S&P Biotech ETF (XBI). Alternatively, Illumina (ILMN) is a great company within this theme that provides the tools required for genomic testing while controlling over 80% of a growing market.

### Asymmetrical Returns for Long-Term Investors

The current environment may be filled with unheralded uncertainty and negativity. However, it’s at this point in the market cycle, after a significant collapse in share prices, that investors who are willing to accept some volatility have the opportunity to buy into wonderful companies at reasonable valuations.

*Please reach out to us should you be interested in these investment opportunities.*

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