Identifying Growing Large Caps in Growing Industries

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Some investors believe that it can be difficult for active managers to add value in the large-cap segment of the equity market. Jim Golan, CFA, and David Ricci, CFA, who co-manage our Large Cap Growth strategy, have a different perspective.

Their investment philosophy is centered on identifying growing companies in growing industries—what they call structurally advantaged companies—whose long-term growth is underappreciated by the market. They believe this approach can deliver a differentiated large-cap portfolio that provides a diversity of growth drivers and a smoother ride for investors, and has the potential to provide outperformance over time.

What is a structurally advantaged company?
David: Simply put, it is a company that we believe will be better off in three to five years than it is today. More

specifically, a structurally advantaged company is likely to grow its share of an industry growing at least as fast as the overall economy.

Can you elaborate on the characteristics of a structurally advantaged company?
Jim: We evaluate not only a company's position within an industry, but also the industry itself. We have to build confidence, through our deep and intensive research process, that a company can sustain an increasing share of its industry's profit pool over the next three to five years. In addition, the industry's profits must be growing at least as fast as the overall economy—preferably faster.

Can you provide an example of a structurally advantaged industry?
David: A good example would be the global animal health industry, which serves companion animals as well as livestock. Companies in this industry provide diagnostic tests, vaccines, and antibiotics to veterinarian clinics and farmers.

The industry is exposed to two secular growth tailwinds. First, with a growing middle class across the globe, especially in emerging economies, people's diets are evolving to include more protein, resulting in steady growth in demand for livestock. Second, coincident with the decline in human birth rates, we have seen an increasing propensity for households to include companion animals and with that, heightened attention to the healthcare of pets. In addition, treatments for companion animals do not have the same type of reimbursement issues as human healthcare, so downward pricing pressure isn't as significant.

As a result of these tailwinds, in addition to new product development and slightly greater corporate concentration, this industry is growing revenue faster than the overall economy with healthy margins.

How does cyclicality impact your three- to five-year industry outlook?
Jim: First and foremost, we evaluate long-term secular drivers to gain confidence about the durability of an industry. Every industry in which we seek to invest exhibits a long-term growth profile that is "up and to the right." However, some industries will have more cyclicality—both in terms of revenue and margins—around that long-term growth trajectory. As a result, we are mindful of where an industry lies on its profit life cycle.

David: For example, the U.S. home-improvement industry is correlated to existing home sales as well as overall consumer discretionary income; both are influenced by interest rates. In late 2008, following the Great Recession, the housing industry was hard hit and home improvement spending was depressed significantly. While the recovery of the industry was likely to be slow, the U.S. Federal Reserve committed to supporting the economy with sustained low interest rates. As a result, we had good visibility on a long-term recovery in home-improvement spend from levels that were not only below peak, but also below the long-term trend.

How do you evaluate whether a company is likely to take share of industry profit pool?
David: We look at a variety of historical and forward-looking measures to both quantitatively and qualitatively assess the durability of a company's competitive advantage. Some examples include the effectiveness of research-and-development spend, strong company culture, product patents, unique distribution, pricing power, and financial strength.

Ultimately, these attributes allow a company to build a competitive moat that can generate above-average revenue growth, margins, free cash flow, and investment returns over a multiyear period. Our team's collective

experience of more than 100 years is critical in determining the leaders in favored industries.

Why is buying only structurally advantaged companies critical to the success of the strategy?
David: We believe that buying the right companies and holding them for several years is the single most important way we add value. Our intention is to hold companies that create their own economic value, and participate in that value creation as shareholders.

In essence, the companies are working for us and in turn our clients. Companies in healthy industries that are taking share of the industry profit pool typically achieve faster profit growth than the overall market. As emerging and current market leaders, these companies tend to exhibit healthy return on capital and cash flow characteristics, two metrics of importance to us.

Is a structurally advantaged company an automatic buy in your investment process?
David: Not necessarily. While we buy only structurally advantaged companies, we do not buy all structurally advantaged companies. The key question is whether we believe the stock is priced such that it can exceed the return of the index over five years. We don’t spend much time discussing near-term multiples of earnings or cash flow. Instead, our focus is on earnings growth potential and where we think the stock can trade in the future.

We need to have deep conviction in the ability of these companies to deliver total shareholder returns that exceed the market rate of return, which in turn gives us the opportunity to outperform. Our batting average has to be high, so we set a high bar for all new purchases.

Are there other reasons why you wouldn’t buy a structurally advantaged company?
Jim: Portfolio diversification is critically important. We typically own only 30 to 40 stocks, so each has to stand on its own as well as add to the overall diversification of the portfolio. We seek to identify stocks with unique economic drivers relative to other holdings in the portfolio.

For example, if an oligopolistic industry exhibited strong secular growth, we would likely choose to hold only one of the companies—where our confidence in the durability of growth is highest and/or the risk/reward opportunity is most attractive.

Our focus is on identifying the best opportunities within each sector and across market capitalizations, resulting in a portfolio that tends to be broadly neutral relative to the benchmark across sectors and market capitalizations. Diversification across these dimensions has helped provide a smoother experience from a relative performance perspective. Further, it has allowed for our selection of stocks and industries to be the primary driver of relative performance.

This focus on growing companies and industries has been key to our ability to deliver compelling investment outcomes over the years.

David Ricci, CFA, partner, and Jim Golan, CFA, partner, are portfolio managers on William Blair’s U.S. Growth Equity team.

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