PM Perspectives: Dynamic Growth Equity

Pure growth is our defining principle

PM Perspectives is a series of profiles highlighting the current views of senior investment leaders across Allspring. You can find this and prior installments of the series at allspringglobal.com.

Recently, we sat down with Tom Ognar, CFA, managing director and senior portfolio manager of the Dynamic Growth Equity team based in Menomonee Falls, Wisconsin. As has become tradition, we've asked Tom to give some color on the team's strategic positioning in the growth equity space and on its long-term value proposition to investors. We then asked Tom to dig into some of the important dynamics that are informing the team's approach to markets today.

TOM OGNAR, CFA

Managing Director and
Senior Portfolio Manager
Dynamic Growth Equity Team

Q: WE OFTEN HEAR YOU USE THE TERM "PURE GROWTH" WHEN YOU DESCRIBE YOUR INVESTMENT APPROACH. CAN YOU DEFINE THIS FOR US?

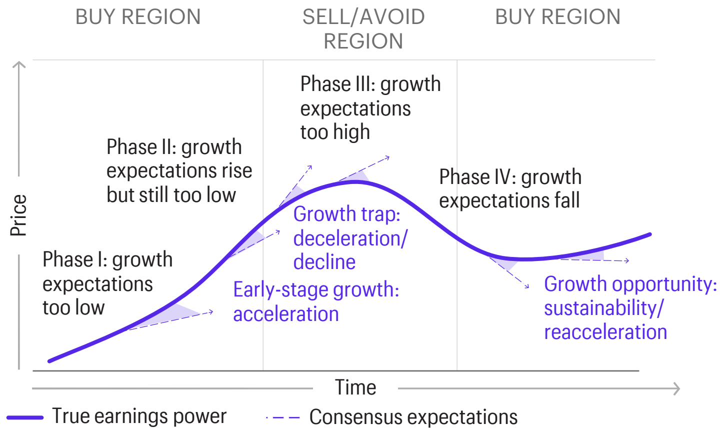
A: Our investment process is defined by the ability to identify companies that can compound higher growth rates over time. The companies we target share a few key attributes. First, they should generate robust, top-quartile growth in earnings, revenues, or cash flows in their respective industries. Second, growth must come from sustainable drivers that are not overly reliant on cyclical tailwinds or faddish investment themes. The companies that demonstrate these attributes are considered pure growth, and this profile defines our style orientation among our peers. Our portfolios also generally have had higher growth rates than their benchmarks because of this focus.

Q: SO, IN A NUTSHELL, PURE GROWTH DEFINES YOUR POSITION WITHIN THE BROADER GROWTH EQUITY UNIVERSE. HOW DO YOU SEEK TO ADD VALUE FOR INVESTORS IN THIS SPACE?

A: The way we seek to add value begins with identifying companies that meet our pure growth standard. If we think a particular company's growth duration is underappreciated by the market, it creates an opportunity for our process to exploit the gap in expectations. As a growth manager, we aren't afraid to pay up for growth, but we need to understand what is still underappreciated relative to expectations reflected in the stock's price today. This is a core element of our valuation framework that is key to long-term success. Needless to say, markets and company growth prospects are dynamic, so when new information changes our view on a stock's valuation or on the issuing company's underlying growth prospects, we act decisively.

Our process creates buy and sell signals over the course of a company's earnings cycle. We firmly believe the best growth managers have to be as talented at selling stocks as they are at buying them. We formally track how well we do on our sell decisions and have done so for more than 15 years. I think this helps us stay true to our discipline and ensure that our investment thesis for every company remains relevant and timely. Below is a conceptual illustration of this process.

FIGURE 1: THE BEST GROWTH INVESTMENTS EXHIBIT ROBUST, SUSTAINABLE, AND UNDERAPPRECIATED GROWTH



Source: Allspring

Our value proposition goes beyond stock selection. We position ourselves as a diversified growth equity manager. Note that our definition of robust earnings is an industry-relative concept (i.e., we seek companies with top-quartile growth against industry peers) because different industries have inherently different growth rates, growth drivers, and risks. This means that we apply the pure growth concept across industries and sectors to build portfolios that are broadly diversified. From an allocation standpoint, I think this offers investors an efficient means to capture the long-term potential of growth stocks over a cycle.

Q: CAN YOU COMMENT ON SOME OF THE SYSTEMATIC FACTORS THAT AFFECTED PERFORMANCE IN 2022?

A: Last year, slowing economic growth and rising interest rates punished all risk assets, and growth equities in particular due to their relatively higher sensitivity to these factors. Our pure growth orientation placed us firmly against these cyclical headwinds. But, as we look forward, the brutal sell-off last year created some openings to build positions in companies that were unduly punished.

2022 also saw the abatement of some of the themes that drove equity markets since the onset of the pandemic. The "stay-at-home" factor, meme stocks, special purpose acquisition companies, and concentrated portfolios in mega-cap tech stocks all had their day in the sun, but their success proved fleeting as markets caught down to reality. Fads generate enthusiastic fan clubs and strong momentum on the way up, but they bear resemblance to many of the excesses that built up during the housing crisis; the technology, media, and telecoms bubble; and countless other manias that preceded. The key point is that erroneous projections are features of market cycles that can be anticipated and managed. Because of this, staying true to a fundamental investment discipline throughout a cycle is the key to generating alpha[1].

Q: INFORMATION TECHNOLOGY (IT) IS AN IMPORTANT SECTOR IN GROWTH EQUITIES, REPRESENTING ABOUT 43% OF THE RUSSELL 3000 GROWTH INDEX[2] BY MARKET VALUE. WHAT ARE YOUR VIEWS ON THE SECTOR AND ON THE INFLUENCE OF TECHNOLOGY ACROSS MARKETS?

A: We are allowed to over- or underweight the IT sector within our limits, but we sustain a market allocation today because we are finding attractive companies there that fit our investment process. It's important to remember that there is a lot of diversity and many business models to select from in this sector. With this said, one thing we are not is what I like to call "venture capital" investors in public equity markets. Some tech and biotech firms are early-stage investments. A few will likely end up being wildly successful, but history tells us that a majority will fail. Trying to choose winners at this stage of a company's life cycle is not the type of investing we try to do, nor does it align with our pure growth style.

Generally speaking, how a company is technically classified as a constituent of a particular sector is not important. Across the board, we seek companies that can sustain growth through competitive advantages or business model differentiation and that can consistently compound higher returns over long periods—not only in brief cyclical upswings. Ideally a company should be able to fund its own growth. We gauge this by understanding the expected returns on its business model and gaining visibility into where cash will be generated and how it will be deployed. When we buy a stock, we are buying the right to a future set of cash flows, and we want to have conviction that these cash flows are durable. The IT sector provides ample opportunities that fit the characteristics I outlined above, so it remains fertile ground for selection.

1. Alpha is the risk-adjusted excess return of a portfolio to its benchmark.

2. The Russell 3000 Growth Index measures the performance of the broad growth segment of the U.S. equity universe.

Q: SOME OF YOUR PORTFOLIOS HAVE A SIGNIFICANT OVERWEIGHT TO THE FINANCIALS SECTOR. CAN YOU COMMENT ON YOUR VIEWS IN THIS SPACE?

A: I think it's important to note that we are not investing in traditional, credit-sensitive financials, like banks. The fastest-growing lenders tend to get there by taking on excess risk. This is not what we want. Rather, our focus within financials tends to center on technology-enabled businesses with high recurring revenue streams.

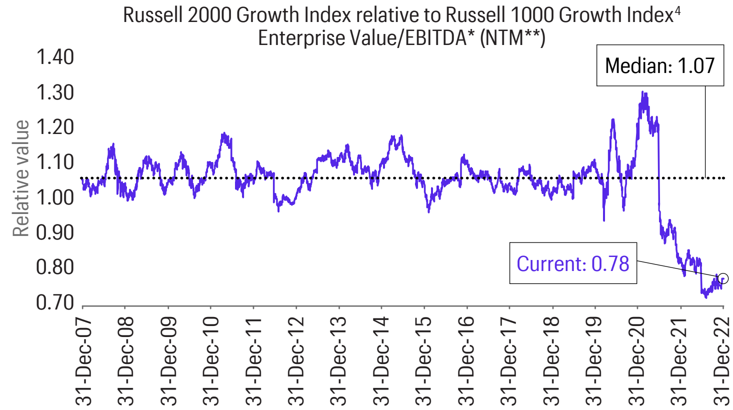
I can give you a few examples. We have been long-time investors in fixed income trading platforms that we believe have a long runway for growth and that possess the type of earnings sustainability and scalable competitive advantages that fit our pure growth profile. We also have numerous investments in payments and related technologies that enable digital money transfers. Fee-for-service investment advice is another attractive area. Baby Boomers have achieved significant wealth levels, making the profitable delivery of advice sustainable and predictable. These platforms are achieving strong growth rates and have improved their profitability as interest rates have risen. The question now, as always, is what level of profitability these platforms can sustain over the longer term, but this segment clearly demonstrates compelling growth to me today.

Q: WHAT MARKET DYNAMICS DO YOU SEE PLAYING OUT IN 2023?

A: About a year ago, we wrote about the ebb and flow of name concentration in growth equity indexes, focusing on the historical concentration cycle in the Russell 1000 Growth Index[3] extending back to 2001. At the beginning of 2022, the top 5 names in the index represented nearly 40% of its market value and the top 10 names made up about half. This followed an extended buildup in name concentration from June 2015 through December 2021 and culminated in multi-year highs in mega-cap valuations. We expected breadth to improve over the course of 2022, and it has.

One of our key findings from this study was that periods of growing concentration corresponded to underperformance of active managers in the space. Periods of growing breadth, on the other hand, correlated to active manager outperformance. I believe we are now in the early stages of improving market breadth, and we are seeing compelling opportunities down market cap—particularly within mid- and small-cap segments. Small caps have recently priced at a nearly 27% discount to their median dating back to the Global Financial Crisis.

FIGURE 2: SMALL-CAP RELATIVE VALUATIONS ARE AT DECADE-PLUS LOWS



*EBITDA = Earnings before interest, taxes, depreciation, and amortization
**NTM = Next 12 months
Source: FactSet, as of December 31, 2022
Past performance is not a reliable indicator of future results.

We have a separate piece that provides more detail on our views of current opportunities in 2023 and beyond, but suffice to say here that I think the market is presenting an exciting opportunity for investors to make the cycle work to their advantage in the coming years.

This brings me to my final point. We have a clearly defined investment process that has endured multiple market cycles. We're coming through a cycle now that has gone against growth stocks, but the best long-term opportunities tend to arise out of these rotations. Bottom line, I think the key to success for investors in 2023 will be to maintain patience and conviction in their strategic growth allocations and in the managers who think independently and stay true to their disciplines.

3. The Russell 1000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe

4. The Russell 2000 Growth Index measures the performance of the small-cap growth segment of the U.S. equity universe.

For further information

We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To learn more, investment professionals can contact us.

Contact details

FOR U.S. INVESTORS ONLY

- To reach our U.S.-based investment professionals, contact your existing client relations director, or contact us at **AllspringInstitutional@allspringglobal.com**.
- To reach our U.S.-based intermediary sales professionals, contact your dedicated regional director, or call us at **1-888-877-9275**.
- To reach our U.S.-based retirement professionals, contact Nathaniel Miles, head of Retirement, at **nathaniel.s.miles@allspringglobal.com**.
- To discuss sustainable investing solutions, contact Henrietta Pacquement, head of Sustainability, and Jamie Newton, deputy head of Sustainability, at **henrietta.pacquement@allspringglobal.com** and **jamie.newton@allspringglobal.com**.

FOR NON-U.S. INVESTORS ONLY

- To reach our non-U.S.-based investment professionals, contact us at **AllspringInternational@allspringglobal.com**.