What Happened to Growth?

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ALEX BERNSTEIN: Hello, I'm Alex Bernstein and you're listening to The Alger Podcast, Investing in Growth and Change. It may come as no surprise to investors that equities and growth equities, in particular, were hit hard in 2022. At Alger, as investment managers with a focus on growth investing, we've gotten quite a few questions from investors about what exactly happened to growth last year? Here to take a deep dive with me into some of those questions is Alger Client Portfolio Manager, Kevin Collins.

Kevin, thank you so much for joining me this afternoon.

KEVIN COLLINS: It's my pleasure, Alex, great to see you again and always enjoy being with you and having our conversations.

ALEX: So, Kevin, what exactly happened to growth in 2022?

KEVIN: Yes, in 2022, we believe growth stocks experienced a massive revaluation. Their valuations became compressed because we think investors were concerned with the prospect of higher interest rates, and because growth stocks' earnings are realized over long periods of time, the higher the discount rate moves, can have a big impact on valuations. And that's what happened in 2022. Many of these growth companies we believe did quite well fundamentally, but the negative returns associated with growth stocks were in large part driven by a massive valuation compression, the likes of which you or I haven't seen in our lifetimes. It was very significant, and it was compressed into a short period of time.

We believe it began in the fall of 2021 when Chairman Powell said he was going to begin hiking interest rates. And we went from essentially a zero interest rate policy to now having a federal funds rate up at about 4.5 percent.

We think there was also a big exacerbating factor in the form of the Ukraine crisis. And the war in Europe took a lot of people by surprise. The war had the effect of increasing inflation, not just with higher energy prices, but with also disrupted supply chains. And so that war has had an effect of elevating the inflationary backdrop and extending its impact over time. So that has negatively affected growth stock valuations.

We believe growth stock valuations are affected more than say value stocks or cyclical stocks because those types of companies have a high current rate of earnings, and we believe those companies typically need the tailwind of a strong economy to do well fundamentally. Whereas you know Alex, from our time at Alger that we believe growth stocks that are driven by innovation, unique intellectual property, a competitively advantaged business model, typically they can do better in times of economic contraction. We believe they create their own market; they have competitive wherewithal to exploit that, reach out, grab that market opportunity, and help to ensure growth in difficult times.

ALEX: And against this backdrop of inflation, Ukraine, supply chain problems, and interest rate hikes, what happened to investor sentiment?

KEVIN: We think sentiment can affect returns more than business fundamentals in the short term, that kind of popularity contest or what's good today is reflected disproportionately in near term results. However, as you hold a stock or a portfolio and allow the underlying business fundamentals to compound out, we believe underlying business fundamentals dictate the long-term returns of an individual stock or a portfolio. And if you were to graphically look at that, that line is quite tight over longer periods of time. So, in a given year, investor sentiment can have a disproportionate impact on the realized returns in that year and can overwhelm the effect of the business fundamentals. So we think that's what happened in 2022.

ALEX: What's interesting to me, is that, despite all the tectonic market movements, underlying business fundamentals for the most part actually stayed relatively strong. Is that accurate?

KEVIN: Yes. We believe business fundamentals grew. The business fundamentals, as they're projected in this coming year by consensus estimates on Wall Street, are expected to outgrow their respective growth indexes and the broad market itself. And if you look back historically, in times of economic contraction, earnings realization is much superior in growth stocks than it is in value stocks.

ALEX: So, I'd say that it's important to note that for many of these companies that struggled, their fundamentals weren't actually broken?

KEVIN: Yes. We believe that's an accurate statement. Many of these companies actually flourished. As 2022 wound down, even some of the very finest companies were experiencing lower rates of growth. That's indicative of a slowing economy and while their growth rates may have slowed, the growth rates are still well in excess of not just the economy, but general corporate America's earnings growth.

ALEX: Kevin, we've been speaking broadly about the markets and growth stocks in 2022. But what happened to many of the Alger portfolios, as a result of that?

KEVIN: We were impacted more negatively. The style purity of our portfolio is that embrace of the long-term growth factor is Alger's investment mandate. And we value that highly. We respect our clients' decisions to allocate to the long-term growth factor. Over long periods of time, we believe that high level of compounding business fundamentals typically results in an appropriate reward for our clients.

ALEX: Kevin, one interesting aspect is that during the downturn, some growth stocks actually became relatively inexpensive. Is that correct?

KEVIN: If you look back historically, particularly in the small cap area, small cap growth, if you look on a cash flow basis, was actually at a discount in valuation to small cap value, which you rarely see. And smaller companies broadly are at historic discounts to large cap companies. We haven't seen this level of discount in small cap companies relative to large cap since 2002. And after that period in 2002, there was a notable relative outperformance in small cap stocks relative to large cap stocks.

ALEX: And so, what do you see happening today in the markets? Do you think growth will make a comeback this year?

KEVIN: Well, we've seen it year to date, Alex. The growth indexes have outperformed the broad market. Investors seem to be, as you said, starting to discount the end, or certainly a pause in the interest rate hike cycle. And it stands to reason that as rates become less impactful, growth stocks might experience a reconsideration, a renewed interest by investors.

ALEX: Kevin, one question that's come up is that, in the case of some of these underperforming holdings whose underlying fundamentals were so strong, did we actually add to any of those names? And if so, could you give us an example?

KEVIN: Yes, certainly. We believe we've had a lot of good opportunities, areas of semiconductors, like hyperscale processors that are at the heart of any of the innovations that we talk about at Alger, cloud computing, autonomous vehicles, IoT, artificial intelligence, they all require very substantial, fast, significant mathematical computational power, instantaneously. And so that area, when it's sold off, we made a notable increase in a leading company in that area of semiconductors.

I would also say on the small cap side, we took the opportunity to increase our positions in a company that is a leading platform, digital platform that is recasting the way that prototype manufacturing is conducted, how bids and business flow between manufacturer and customer are executed. We believe it's more efficient, it's more transparent, and has great benefit economically to that area of the economy.

ALEX: Kevin, any final thoughts for investors as we look forward to the rest of the year?

KEVIN: Well, typically, we believe market corrections happen in two phases, and what we've just been discussing, Alex, is an example of what happens during phase one of an economic correction, higher interest rates, a valuation compression in stocks. And as you said, the market is looking forward in 2023, they're seeing an economic environment that has slowed, there's been some damage in certain sectors because of these rate hikes of our economy. And investors are thinking that the Fed's hike cycle might end at some point this year. And they've certainly diminished the magnitude of the rate hikes already.

We believe that phase one and the damage it's caused to equity valuations seems to have come to a conclusion. And now investors and Alger have looked to their portfolios trying to scrub economic sensitivity, avoid negative earnings revisions associated with difficult economic times. We feel like we're well set for that and that growth stocks as we explained, really were hurt during that phase one. And now, during phase two, when we're talking about earnings realization in difficult economic environments, we believe historically, growth stocks have done a far better job on a relative basis than other styles of investing. So, we feel like this, the relative performance may improve.

ALEX: Kevin, thanks so much for talking with me this afternoon.

KEVIN: Thanks, Alex. Great talking with you.

ALEX: And thank you for listening. For more information on investing in growth and for more of our latest insights, please visit www.alger.com.

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