March 29, 2021

Rather be Lucky than Good

All-star New York Yankees pitcher Lefty Gomez once said: "I'd rather be lucky than good." Successful investing over time is, however, not a game of luck.

It requires discipline and skill. In today's markets, some fast growing, unprofitable and highly-valued companies have outperformed. These stocks and other signs of market exuberance amid rising economic uncertainty warrant investors' attention.

Investors in U.S. assets experienced this type of market performance during the tech bubble in the late 90s when unprofitable companies soared. More recently, the narrowing of the U.S. market has garnered much attention among investors, specifically how fast-growing companies like Tesla are driving the bulk of returns.

A similar phenomenon has occurred in the international space, but it has not been as widely discussed. In this paper, we analyze international equities (global excluding U.S.). Broadly, the conclusion is the same across markets around the globe – growth at any price is performing in a way that has preceded major reversals in the past. One way to prepare for a downturn is to focus on quality businesses with predictable earnings growth.

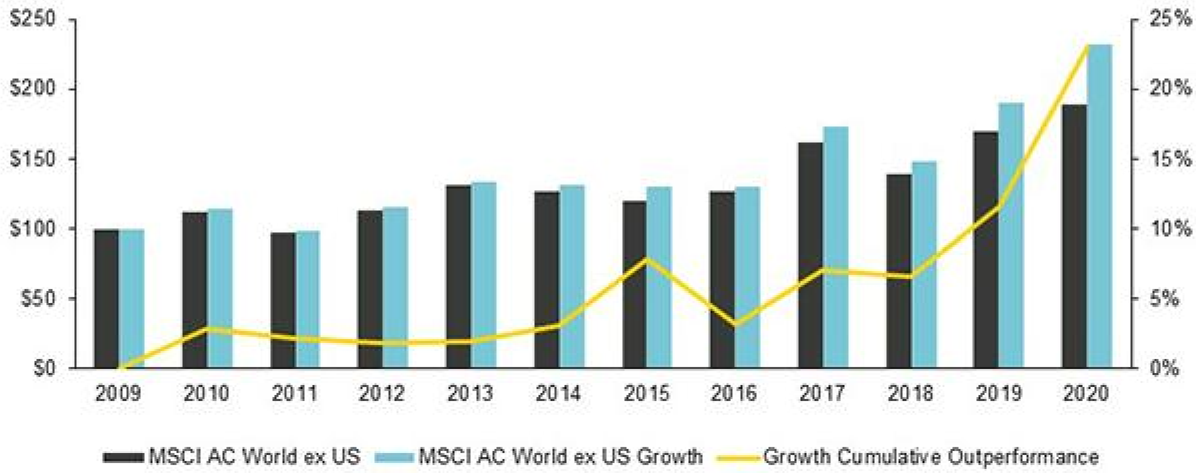
In our view, there are three prominent signs that serious investors should pay attention to in the international equity markets today: 1) Growth outperformance has accelerated, 2) Within growth, "lucky" stocks are outperforming, and 3) Valuations and other signs of exuberance are expanding as economic uncertainty is increasing.

#1: Growth Outperformance has Accelerated

Growth investors experienced a good run from the end of the global financial crisis to today, already over a decade. Had you invested $100 in the international index, the MSCI All Country World (ACWI) ex US, in 2009, by the end of 2020 you would have had almost $190. But that same $100 invested in the international growth index, the MSCI ACWI ex US Growth, would have returned a little over $230. While growth did not outperform each year, growth investors would have been ahead at the end of every year on a cumulative basis.

At the end of 2018, the cumulative difference between the two strategies was not that great, only 7%, as shown in Figure 1 below. But that difference widened to 23% over the next two years — a significant divergence.

FIGURE 1: GROWTH VS. MARKET RETURNS



Source: MSCI, FactSet, Vontobel Asset Management. **Past performance is not indicative of future results.**

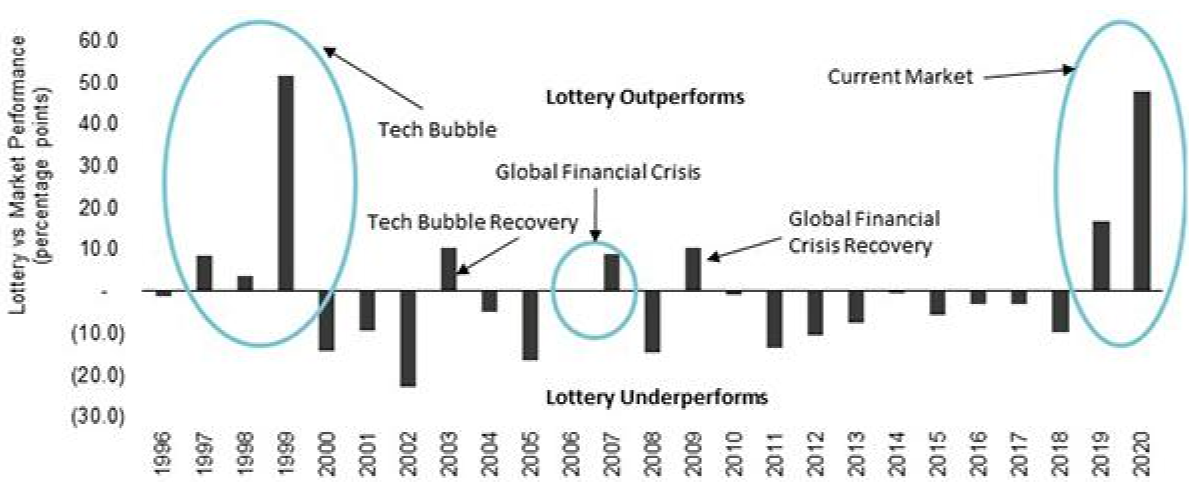
Assuming valuations are reasonable, outperformance of growth stocks can be explained by faster earnings growth than the market overall. But the significant outperformance we have seen recently is more of an outlier and worth looking into.

#2: Within Growth, "Lucky" Stocks Outperformed

When we dig into the numbers, we find something that is out of the ordinary. Over the past two years, the best place to invest was in the more speculative area of growth — fast-growing companies with price-to-earnings (P/E) ratios that are very high or nonexistent due to no earnings. We refer to these as "lucky" stocks.

Not surprisingly, there have been years where these types of companies have done best, and years where they have not, depending on investors' risk appetite. What we have found, however, is that over the past 25 years, there have only been a few cases where "lucky" stocks have outperformed the market for more than one year in a row. These times were 1997-1999, 2006-2007, and 2019-2020. Unfortunately, that puts the current market environment in poor company.

FIGURE 2: "LUCKY" STOCKS OUTPERFORMED BEFORE CRASHES AND EXITING DOWNTURNS



Source: MSCI, FactSet, Vontobel Asset Management. **Past performance is not indicative of future results.** Note: The analysis looks at non-financial companies with market caps above $5B that grew sales more than 20% and had a price-to-earnings (GAAP of the prior year) of over 50x, or no earnings. 2001-2020 is MSCI ACWI ex US, prior are companies in the countries that comprise the MSCI ACWI ex US. The companies are equal weighted (otherwise performance is only driven by the largest-cap companies).

Vontobel portfolio manager David Souccar recently authored Where is Your Umbrella?, where he argues that caution is in order for two types of companies — those that have benefited most from low rates, and "story" stocks, those that have interesting prospects but unproven business models. Those obviously overlap with these "lucky" stock speculations.

Shopify is an example of a fast-growing business where its current valuation assumes everything will go right. This Canadian technology company helps largely small and mid-size businesses set up their online presence, which entails shipping, warehousing, fulfillment, payments, marketing, and customer engagement. There is structural growth behind online shopping and Shopify does a great job. But everything has a price. Perhaps Shopify will grow into its valuation. But investors should remember that a client base of smaller-size companies means that its clients generally have a high failure rate and will be worse off during recessions. Even if successful, the ride may be bumpier than investors currently expect, especially at today's lofty starting point. Based on our calculations, Shopify will need to grow significantly faster than Amazon did (when Amazon was at Shopify's size) in order to earn a decent return at today's stock level. Amazon's success is rare, and repeating it, let alone exceeding it, is a tall order. Shopify offers a great service, but will it make an outstanding investment? Similarly, Just Eat Takeaway, a Dutch food delivery company, needs many things to go right for several years to justify its valuation. While it is growing quickly, it operates in a very competitive space and customer acquisition costs are high.

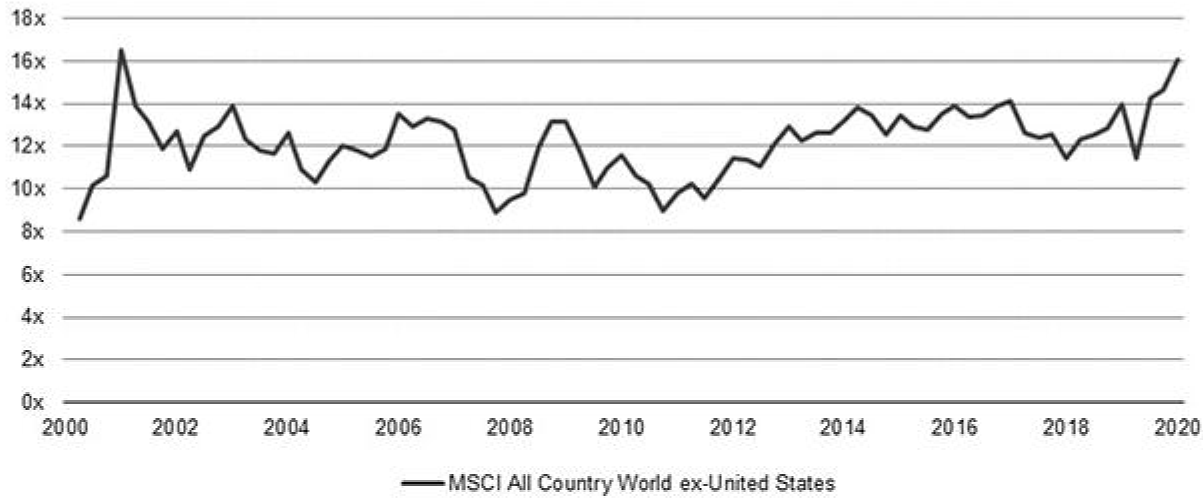
This is not just a developed market phenomenon. We are seeing this across geographies. Interestingly, over half of the companies that fit our "lucky" stock profile today (i.e., non-financial company in the MSCI ACWI ex US Index with 20% sales growth, no earnings or a P/E above 50x) are in China, and largely in domestic China A shares, with another 14% in Hong Kong. Almost a quarter of all the Chinese companies in the MSCI ACWI ex US Index fit these criteria. It does not mean that investors have to avoid that region, but they should be very thoughtful about where they allocate capital in that market.

There are great opportunities in China and while we always look for growth, we also have to make sure that the investment is backed by durable, proven businesses at sensible prices. For example, many investors try to access the growth of the Chinese pharmaceutical sector through Jiangsu Hengrui. But this sector is unproven in China and works differently than in other countries. China is a single-payer market, and while the government is expanding healthcare coverage, it also focuses on keeping overall healthcare expenditure growth in check. This results in frequent policy changes and less pricing power compared to Western markets. Drugs in China will also have more compressed lifecycles than in other markets, as they can reach peak sales more quickly but will also experience quicker and more dramatic pricing erosion. In an industry with less certainty given the nature of drug development, plus high levels of government intervention, valuations appear to embed a lot of success.

#3: Expanding Valuations and Other Signs of Exuberance at a Time of Rising Uncertainty

At a time when soaring "lucky" stocks are concerning, we also note other items that warrant caution. Valuations have expanded overall (Figure 3) and the economic outlook looks murky and is skewed to the downside. The number of global IPOs and the amount of cash chasing those IPOs is enormous. Within the IPO space, the rise of special purpose acquisition companies (SPACs), investors bet on a manager or team to not only run a business well, but first find a business to run. The market is not acting rationally. Anecdotally, GameStop, a traditional retailer that has seen sales decline for years (and therefore does not fit the mold of companies discussed above) as video games are increasingly downloaded, saw its stock increase many times over in the first few weeks of the year driven by retail investors causing a short squeeze. This is one sign that investors should heed caution, reminding us that markets are not always efficient. Risks do not go away when they are out of mind. In fact, it is quite the opposite — risks increase the more they are ignored.

FIGURE 3: MSCI ACWI EX US INDEX FORWARD P/E



Source: FactSet, as of December 31, 2020.

One way to protect against a potential reversal is by not focusing on growth to the exclusion of all else. This is not to imply that a given business cannot be on the path to greatness, but when the market only looks at a company's potential and ignores the risks, it pays to be wary. Growing companies that also have a proven, high-return business model today, and trade at reasonable valuations, are a more conservative and historically fruitful way to protect in a market downturn, and can provide a smoother ride through the cycle.

In our view, a quality-growth manager should not singularly focus on growth, but look for quality businesses first. While this approach may exclude some of the fastest-growing companies, we believe investing in growth for the sake of growth is not a great strategy. But seeking to invest in profitable growth is. Ultimately, successful investing over time is not a game of luck, but an endeavor that requires discipline and skill.

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