William Blair

Investment Management
active.williamblair.com

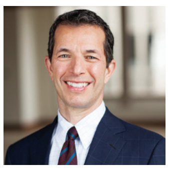
Identifying Growing Large Caps in Growing Industries

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.

August 2020

Portfolio Managers, William Blair's Large Cap Growth Strategy
James Golan, CFA, Partner
David Ricci, CFA, Partner

James Golan, CFA, Partner



David Ricci, CFA, Partner

Golan's and Ricci's 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 a growing industry.

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 an attractive industry, based on this framework?

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.

"Companies in healthy industries that are taking share of the industry profit pool typically achieve faster profit growth than the overall market."

David Ricci, CFA, Partner

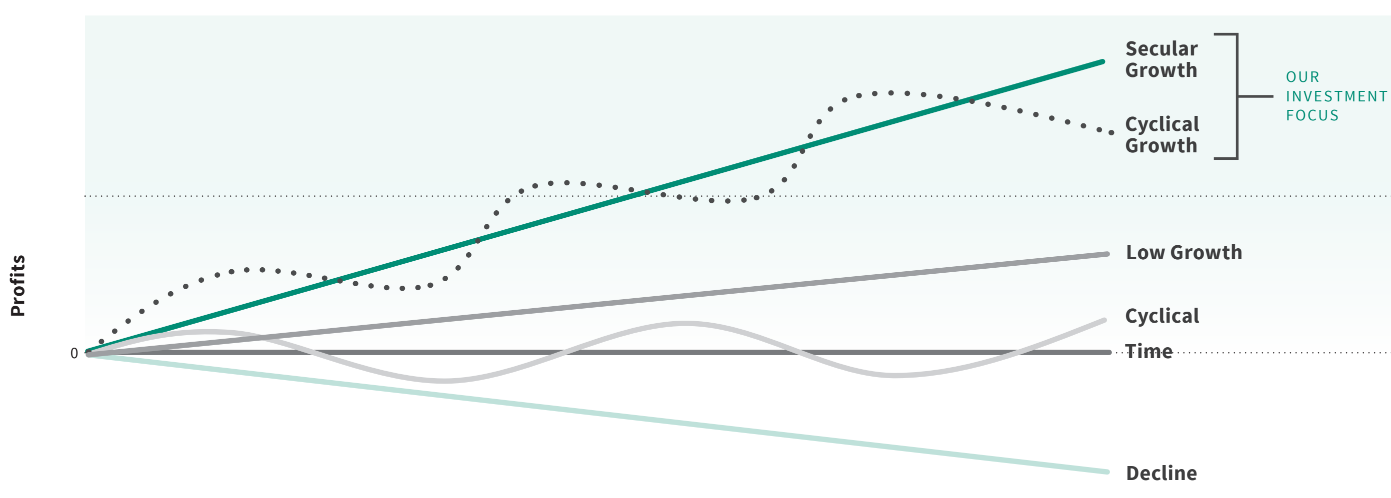
How do you evaluate whether a company is likely to take share of industry profit pool?

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.

EXHIBIT 1

Industry Lifecycle Assessment

Identifying Attractive Industries



For illustrative purposes only.

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.

Biographies

James Golan, CFA, Partner

Jim Golan, CFA, partner, is a portfolio manager on William Blair's Large Cap Growth strategy and a research analyst covering U.S. large-cap technology stocks. From 2000 until 2005, when he assumed his current role, Jim was a research analyst focusing on financial, technology, industrial, and resource stocks. Before joining William Blair in 2000, he worked at Citigroup Global Asset Management, where he was a global research team leader for the telecommunications sector and a key member of the team that devised valuation metrics for standardizing the analysis of domestic and international companies. Jim began his career at Kemper Financial as a research analyst covering telecommunications, technology, energy, industrial, food, and beverage companies. He is a member of the CFA Institute and the CFA Society Chicago. Jim received a B.A. in economics from DePauw University and an M.B.A. in finance from Northwestern University's Kellogg Graduate School of Management.

David Ricci, CFA, Partner

David Ricci, CFA, partner, is a portfolio manager on William Blair's Large Cap Growth strategy, which he joined in 2011. From 2005 to 2018, he was also a portfolio manager on the Mid Cap Growth strategy. Previously, he was the group head for the consumer sector, focusing on specialty retail and e-commerce companies, in William Blair's sell-side research group. Before joining William Blair in 1994, David gained extensive experience at Procter & Gamble, Melville, and Bain & Company. He is a member of the CFA Institute and the CFA Society Chicago. David received a Sc.B., *magna cum laude*, from Brown University and an M.B.A. from Harvard Business School.

About William Blair
William Blair is committed to building enduring relationships with our clients and providing expertise and solutions to meet their evolving needs. We work closely with most sophisticated investors globally across institutional and intermediary channels. We are 100% active-employee-owned with broad-based ownership. Our investment teams are solely focused on active management and employ disciplined, analytical research processes across a wide range of strategies. As of June 30, 2020, we manage $56.8 billion in assets. We are based in Chicago with resources in New York, London, Zurich, Sydney, Stockholm, and The Hague, and dedicated coverage for Canada.

Important Disclosures
This material is provided for information purposes only and is not intended as investment advice, offer, or a recommendation to buy or sell any particular security or product.

This material is not intended to substitute a professional advice on investment in financial products and any investment or strategy mentioned herein may not be appropriate for every investor. Before entering into any transaction each investor should consider the appropriateness of a transaction to his own situation and, the need be, obtain independent professional advice as to risks and consequences of any investment. William Blair will accept no liability for any direct or consequential loss, damages, costs or prejudices whatsoever arising from the use of this document or its contents.

Any discussion of particular topics is not meant to be complete, accurate, comprehensive, or up-to-date and may be subject to change. Data shown does not represent and is not linked to the performance or characteristics of any William Blair product or strategy. Factual information has been taken from sources we believe to be reliable, but its accuracy, completeness or interpretation cannot be guaranteed. Information and opinions expressed are those of the author and may not reflect the opinions of other investment teams within William Blair. Information is current as of the date appearing in this material only and subject to change without notice. This material may include estimates, outlooks, projections and other forward-looking statements. Due to a variety of factors, actual events may differ significantly from those presented.

Past performance is not indicative of future returns. Investing involves risks, including the possible loss of principal. The strategy invests most of its assets in equity securities of large cap domestic growth companies where the primary risk is that the value of the equity securities it holds might decrease in response to the activities of those companies or market and economic conditions. Individual securities may not perform as expected or a strategy used by the Adviser may fail to produce its intended result.Different investment styles tend to shift in and out of favor depending on market conditions and investor sentiment, and at times when the investment style used by the Adviser is out of favor, the strategy may underperform strategies that use different investment styles. Diversification does not ensure against loss. Any investment or strategy mentioned herein may not be appropriate for every investor.

This material is distributed in the United Kingdom and the European Economic Area (EEA) by William Blair International, Ltd., authorized and regulated by the Financial Conduct Authority (FCA), and is only directed at and is only made available to persons falling within articles 19, 38, 47, and 49 of the Financial Services and Markets Act of 2000 (Financial Promotion) Order 2005 (all such persons being referred to as "relevant persons"). This document is distributed in Australia by William Blair Investment Management, LLC ("William Blair"), which is exempt from the requirement to hold an Australian financial services license under Australia's Corporations Act 2001 (Cth) pursuant to ASIC Class Order 03/1100. William Blair is registered as an investment advisor with the U.S. Securities and Exchange Commission ("SEC") and regulated by the SEC under the U.S. Investment Advisers Act of 1940, which differs from Australian laws. This document is distributed only to wholesale clients as that term is defined under Australia's Corporations Act 2001 (Cth).

This material is not intended for distribution, publication, or use in any jurisdiction where such distribution or publication would be unlawful. This document is the property of William Blair and is not intended for distribution or dissemination, directly or indirectly, to any other persons than those to which it has been addressed exclusively for their personal use. It is being supplied to you solely for your information and may not be reproduced, modified, forwarded to any other person or published, in whole or in part, for any purpose without the prior written consent of William Blair.