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Growth potential

This year has seen a lot of hype around value investing, but is it time to take another look at growth companies?

There's no denying growth investing has taken a hit in the last year or so as value investors have seen their patience rewarded. But that doesn't mean that growth is dead.

The thing about growth stocks is they don't get along with inflation; their pricing power is depressed as expenses increase. This gives rise to a tailwind for value-style investments as future earnings become less valuable and greater value is place on a company's current earnings.

For much of 2021, US Federal Reserve chair Jerome Powell maintained that any increase in inflation on the back of the world's pandemic recovery would be transitory, suggesting a rise in inflation wouldn't leave a mark on the global economy. By the end of 2021, the 'transitory' tag was dropped by the central bank as the Consumer Price Index rose.

Growth stocks have obviously been challenged over the last year or so, Franklin Global Growth Fund portfolio manager Francyne Mu says.

"It seems like we've been lurching from one crisis to another with COVID lockdowns, supply chain issues which have now transpired into inflationary pressures and, now with the increase in interest rates, people are talking more about recessionary risks going forward," she says.

However, while it peaked in the US at 9.1% in June, forecasts now suggest inflation is decreasing, expected to come in at 8.7% for July.

While it may not be indicative of a forward trend, it begs the question: what if inflation really is transitory? And, if so, what does that mean for growth investors?

"Obviously in a time where we've got rising interest rates, you tend to see some of these growth stocks with long tail risks suffer multiple compression, which is what we've seen to date," Mu explains.

But that doesn't mean a switch in investment style; it simply calls for a different approach.

The Franklin Global Growth Fund has just that, doing growth slightly differently.

Focused on sustainable growth companies, the fund only invests in those stocks that can provide strong sustainable growth over the long-term. In order to win an allocation, the companies must demonstrate strong free cashflows, have low to no debt on their balance sheets, and should be well positioned going forward.

The companies the Franklin Global Growth Fund team select are typically supported by strong secular growth drivers as well.

"We tend to buy into these names earlier in their growth phase, which will help to generate alpha over the long term," Mu explains.

The fund is typically invested in about 35 companies at any given time, names that can be held over the long term.

In selecting those companies, Mu says the team prides itself on the depth of research undertaken.

"Analysts will bring names to the table, but it can take anywhere from two to six months before a name gets brought into the portfolio," she explains.

In addition to strong, free cashflows and support from secular growth drivers, the companies the team invests in must also be in good market structures and have some form of competitive advantage in their space in order to be considered.

However, what sets the Franklin Global Growth Fund apart from many of its competitors is how the types of companies chosen help to combat the threat posed by rising interest rates. Because a lot of the companies within the portfolio have little to no debt on their balance sheets, they're going to be impacted less on a relative basis by any increase in rates.

Further, in selecting stocks the team tends to go down the market cap spectrum, Mu explains.

"We're really looking for those names that have sustainable growth over the long term and that are earlier in the growth phase," she says.

"They're the companies that can grow with us over time."

To illustrate, Mu points to Intuitive Surgical, a current holding in the fund. Part of the NASDAQ-100 and S&P 500, Intuitive Surgical is a 27-year-old US corporation that develops, manufactures, and markets robotic products designed to improve clinical outcomes of patients through minimally invasive surgery.

Mu says Intuitive Surgical isn't getting the credit in the market that it deserves, despite its preeminence in the robotic surgery space as inventor of the da Vinci Surgical System. Created in 2000, the da Vinci system is most used for prostate removals and hysterectomies, and increasingly for cardiac and renal procedures.

With a market cap of $74 billion and somewhat of a monopoly on urological surgery, Mu likes Intuitive Surgical and intends keep of hold of it, expecting robotic surgeries will increase in penetration over time.

There are a few factors supporting her belief. First, robotic surgeries result in less blood loss for patients. Couple this with the fact the incisions are a lot smaller, and the recovery time is significantly reduced. As the recovery time is reduced, so too are the hospital stays, saving money for both patients and the hospitals.

"The company generates very strong free cashflow, with free cashflow margins of around 25-30%. It also has very profitable with EBITDA margins of 35-40% and it has no debt on its balance sheet, so interest rate increases aren't going to impact it like they will some of its competitors," Mu explains.

"We believe the company is well positioned over the long term and we're happy to top up the investment given the market dislocation."

Mu is also happy to do this as it's the portfolio's only holding in that space. This is because limiting economic overlaps among holdings is one of the fund's key mechanisms for managing risk.

"We wouldn't tend to hold two names exposed to the same underlying growth driver. For instance, we wouldn't tend to hold both Visa and Mastercard as they'd be doubling up on the risk. We would only hold one of those names to ensure an exposure to the growth driver that is the move from cash to cards," she explains.

The other main way in which the fund's team manages risk is by capping positions between 2-4%.

"Buying into a position with 20-50 basis points doesn't really add anything to the portfolio," Mu explains.

"By the same token, once it hits that 4% level, we tend to cap it there given we don't want outsized risks to dominate the portfolio – if one name falls, it doesn't cascade throughout the portfolio."

Finally, the team also manages risk in a way that many other fund managers do and, in doing so, meets investors' evolving needs – ESG.

For a highly concentrated portfolio of 35 names, the team must consider all risk factors; this can include anything from environmental, social and corporate governance risks to dual share class structures, compensation structures and incentives.

"They all present risk factors for a name when assessing valuations or how we see the company positioned against its peers," Mu says.

"It's very important from that perspective and it is a big part of what we do in the vetting process.

"We believe that slowing growth will slow stylistic adjustments and force the market to refocus on company fundamentals. Companies which are supported by strong secular growth drivers should start to perform and hold their investors in good stead over the medium term." FS

The quote

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Watch the video on www.fsitv.com