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POINT OF VIEW

AUGUST 2023

Asset Management

PAYING FOR GROWTH?

GROWTH SEEMS TO HAVE HAD A TREMENDOUS YEAR SO FAR. BUT HAS IS IT REALLY? A CLOSER LOOK MAY INDICATE OTHERWISE.

2023 has marked a reversal of market and factor trends from the past couple of years. However, growth seems to be the one bright spot for investors. As the market continues to buy into the lofty growth expectations surrounding generative AI stocks and other tech and tech-adjacent names, we took a look under the hood to see what exposures investors are really paying for.

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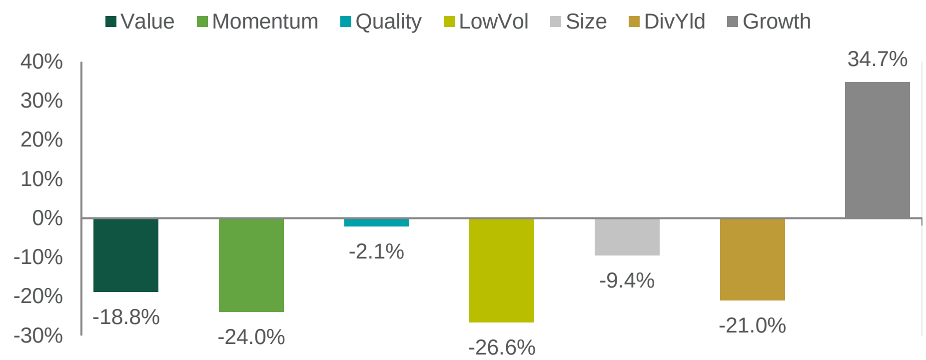
Sectors not Growth

Factors had some of the best years on record in 2021 and 2022. 2023 started off with spring-loaded markets fueled by slowing inflation and hopes of Fed rate cuts. This euphoria ignited a rally in growth stocks which continued into the second quarter. The Russell 1000 Growth Index is up 29.0% versus the Russell 1000 Value Index return of only 5.1% (12/31/2022 – 6/30/2023). Looking at cuts of the market formed on stock level characteristics, the growth factor during this time frame is up nearly 35% against broadly negative returns for other factors such as Value and Momentum (see Exhibit 1).

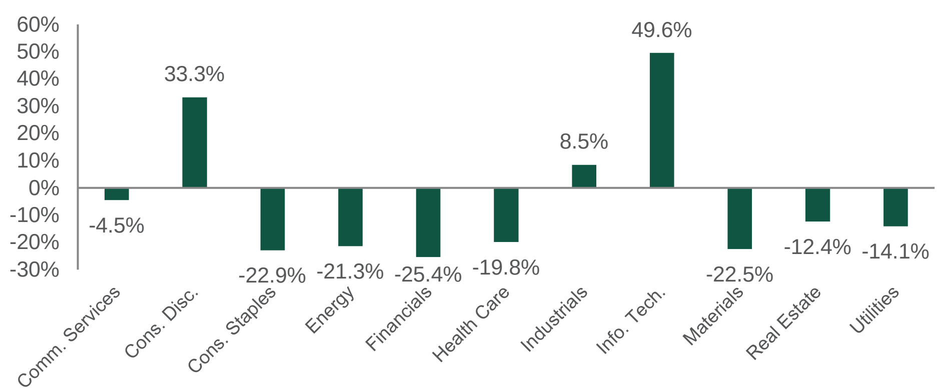
EXHIBIT 1: FACTOR RETURN SUMMARY (Q1-Q5 SPREADS)



Source: FactSet, MSCI Barra. Russell 1000 Index : 12/31/2022- 6/30/2023. Shows performance of Factor Mimicking Portfolios that are long-short. Value, Momentum, Low Volatility, Quality and Dividend Yield are Northern Trust factor definitions which are sector neutral. Growth is sourced from Barra. Size is Market Cap. Represents top minus bottom quintile by count. This graph does not show actual performance results. For illustrative purposes only. Past performance is no guarantee of future results. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

But has growth really had the tremendous year that Exhibit 1 shows? When we dig a bit deeper, we see a very different picture. In fact, when we looked within each sector at the top growth stocks, we see that growth is really only paying off within three sectors, and only meaningfully in two: Consumer Discretionary and Information Technology (see Exhibit 2).

EXHIBIT 2: TOP QUARTILE OF BARRA GROWTH FACTOR SECTOR EXCESS RETURNS (RUSSELL 1000 INDEX)

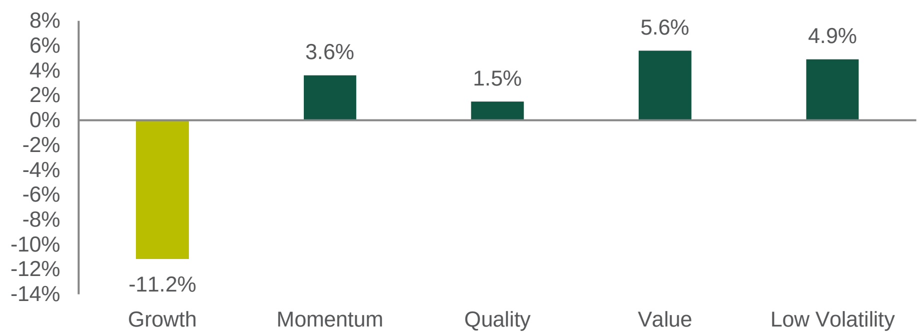


Source: Northern Trust, FTSE-Russell. From 12/31/2022 through 6/30/2023. Shows performance of Top Quartile of Growth (using Barra definition) in each sector relative to the Russell 1000. This graph does not show actual performance results. For illustrative purposes only. Past performance is no guarantee of future results. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

Ideally, when a factor is "working" it is doing so across most segments of the economy. Otherwise, we wonder whether it is the factor at all, or perhaps something else. Naturally, because growth has not worked in 8 of the 11 GICS sectors, controlling for sector exposures significantly reduces returns. In fact, when we compare returns for sector-neutralized factors versus non sector-neutralized factors so far this year, growth is the only factor where sector neutralization has made performance worse, a strong indication that sectors are a significant driver of the factor's success this year (see Exhibit 3A).

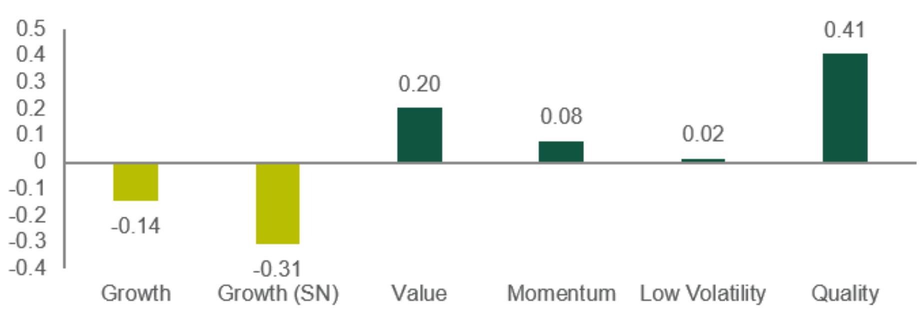
This phenomenon is true looking over 30 years at factor performance as well (Exhibit 3b). Northern Trust's sector neutral Value, Momentum, Low Volatility, and Quality all exhibit positive risk-adjusted returns since 1990. These factors are where investors have been rewarded over the long run. Growth, on the other hand, has negative risk-adjusted returns both on a sector neutral and non-sector neutral basis, with sector-neutral looking worse.

EXHIBIT 3A: SECTOR NEUTRAL VS RAW FACTOR RETURNS (% DIFFERENCE) RUSSELL 1000 YTD 6/30/2023



Source: Bloomberg, Northern Trust, FTSE-Russell. From 12/31/2022 through 6/30/2023. Shows performance of Factor Mimicking Portfolios that are long-short. Value, Momentum, Low Volatility, Quality and Growth are sourced from Bloomberg. Represents top minus bottom quartile by count. This graph does not show actual performance results. For illustrative purposes only. Past performance is no guarantee of future results. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

EXHIBIT 3B:FACTOR ANNUALIZED RISK-ADJUSTED RETURNS 12/31/1989-6/30/2023

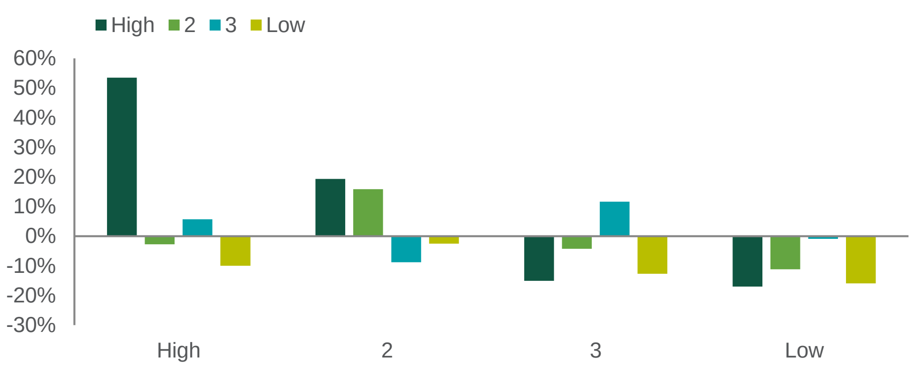


Source: Northern Trust, FTSE-Russell. From 12/31/1989 through 6/30/2023. Shows performance of Factor Mimicking Portfolios that are long-short. Risk-adjusted is calculated by taking the annualized return and dividing it by the annualized standard deviation. SN stands for sector neutral. Value, Momentum, Low Volatility, and Quality are Northern Trust factor definitions which are sector neutral. Growth is sourced from Barra. Represents top minus bottom quintile by count. This graph does not show actual performance results. For illustrative purposes only. Past performance is no guarantee of future results. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

Paying for Volatility

To go another level deeper, we looked at how the growth factor was performing within Volatility groups. In Exhibit 4, we look again at the returns of growth quartiles but within stock-level volatility quartiles. The highest volatility stocks (quartile 1) have a distinctly monotonic payoff to growth year-to-date. But looking at the medium to low volatility groups of stocks, growth is really not a differentiating factor. This is yet another indication that investors are not necessarily paying for growth, but something else; in this case they are paying for the high risk associated with speculation surrounding AI and idealistic growth expectations.

EXHIBIT 4: GROWTH FACTOR QUARTILE EXCESS RETURNS VS VOLATILITY QUARTILES RUSSELL 1000 YTD 6/30/2023



Source: Northern Trust, FTSE-Russell. From 12/31/2022 through 6/30/2023. Low Volatility and Growth are sourced from Barra. Represents top minus bottom quartile by count. This graph does not show actual performance results. For illustrative purposes only. Past performance is no guarantee of future results. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index.

Buyer Beware

While on the surface, growth has performed historically well in 2023, a look under the hood tells a different story. We find that investors are really paying for select sector exposure and higher volatility for the chance of earning outsized returns. The small cohort of high volatility, high growth stocks may have provided benefit in the short-term. However, over the long term, exposure to growth has added to risk and not to returns. Investors are better off staying the course in tried and true factor strategies that have been shown over the long term to provide attractive risk-adjusted returns. That said, investors should not necessarily shun growth stocks altogether. Instead, investors need to be very discerning in how they build growth portfolios to be successful investing in growth over the long term.

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