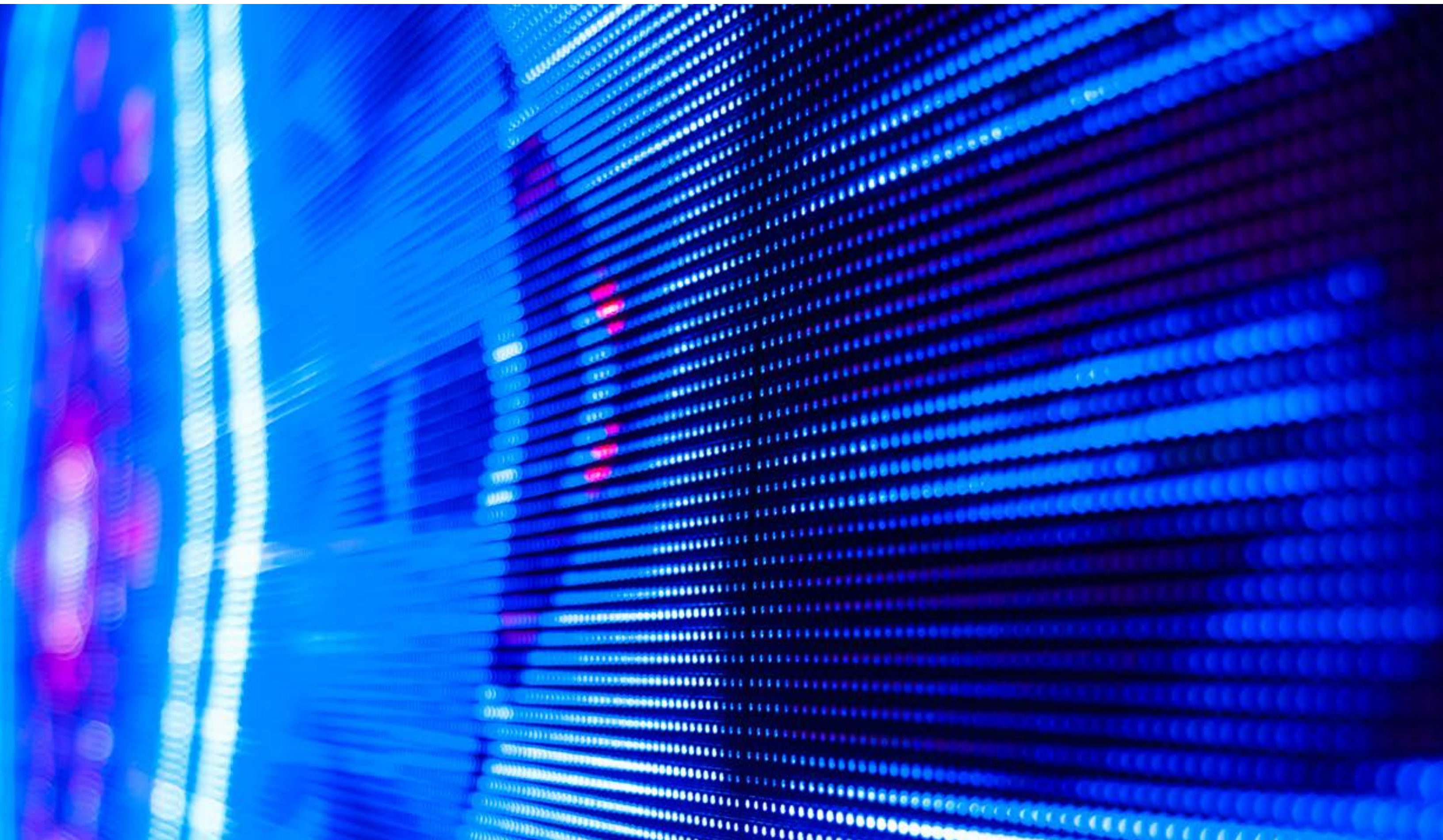
The Spectrum of Growth



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The Spectrum of Growth

- Companies that generate strong, sustainable growth are valuable sources of long-term capital appreciation in a portfolio, but these businesses are rare, difficult to identify, and exist on a broad spectrum.
- The spectrum includes companies ranging across sectors, countries, and stages of their life cycles. We believe the most attractive companies generally fall into one of two main groups: emerging growers and stable growth compounders.
- By applying an empirical lens to these two groups across nearly two decades, we can see how their investment characteristics have affected performance outcomes. This is important for growth investors to know as they steer through different market cycles.
- While this framework helps explain growth equity performance, it is not a substitute for the bottom-up, fundamental analysis that we believe is essential to identify long-term growth investment opportunities.

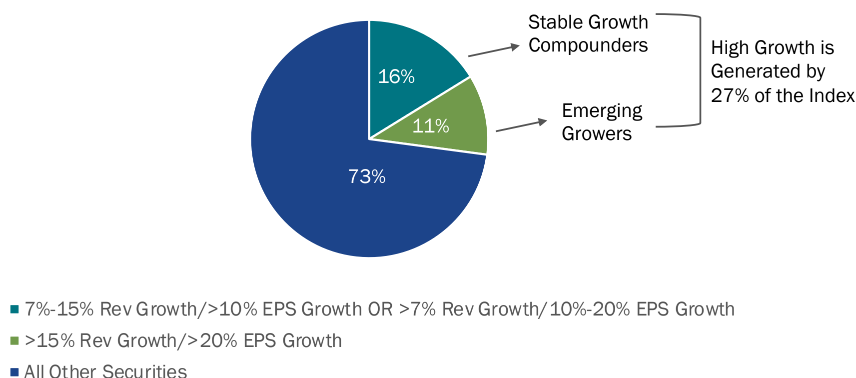
The Growth Landscape

Companies that deliver above-average, sustainable growth over the long term are among the most valuable investments in the markets. These companies generate the strongest compound returns over time, a role that has been amply rewarded by investors. The fastest-growing companies have consistently led performance over the past three decades and through a range of market environments.[1]

Growth companies, however, are rare. Since mid-2005,[2] about one out of four publicly listed large- and mid-capitalization companies globally posted 7% or greater annualized revenue growth and 10% or higher earnings growth. When the revenue growth threshold is raised to 15% and earnings growth to 20%, the number falls to about one in ten companies (Exhibit 1).[3] In the United States, the number of stable growth compounders and emerging growers together is slightly higher than globally—almost one in three companies.

Exhibit 1: Most Growth Is Generated by Just a Quarter of Global Companies

MSCI All Country World Index



Three-year realized revenue growth calculated quarterly, equally weighted. Five-year realized earnings per share growth calculated quarterly, equally weighted.
Data from June 30, 2005 through December 31, 2023.
Source: FactSet, Jennison

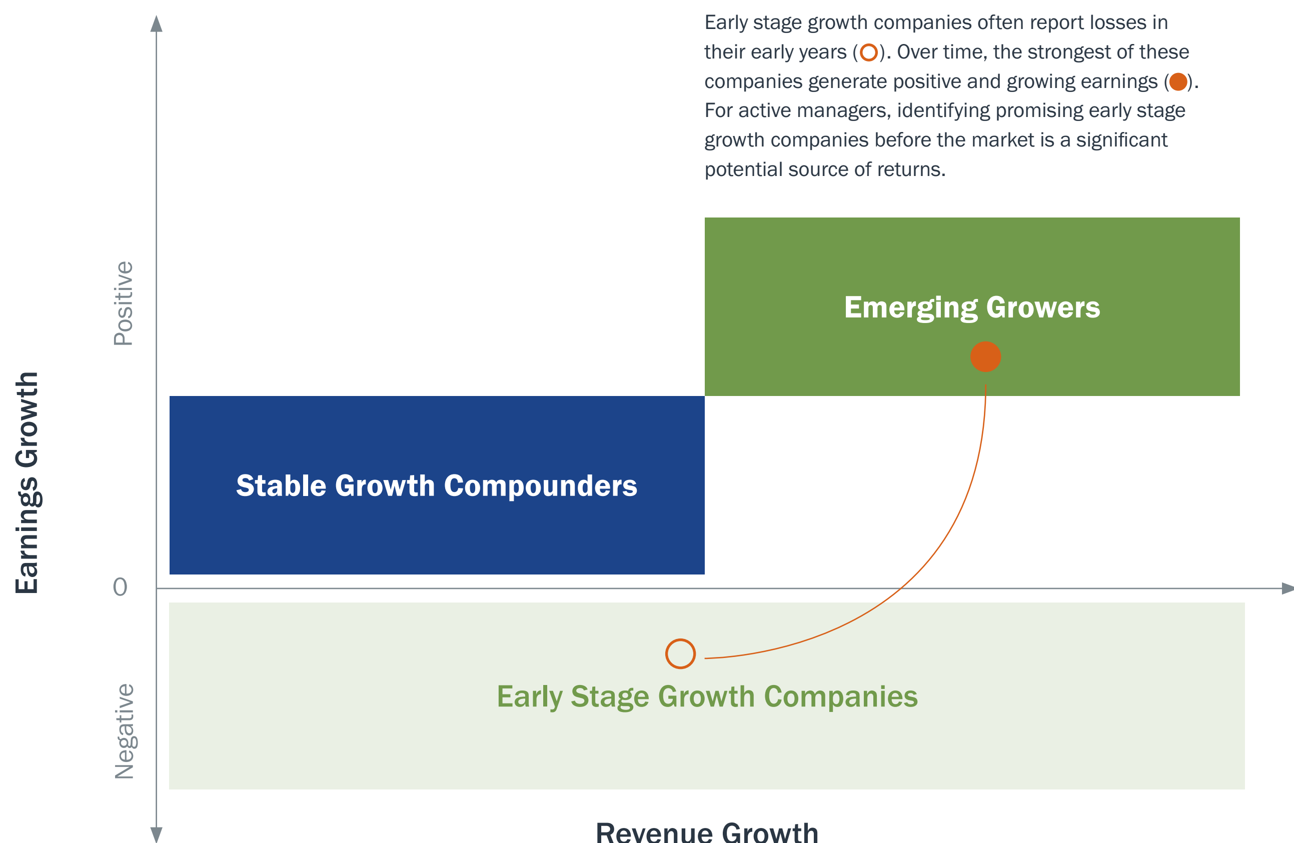
The sources of growth can vary and are often fluid. While strong, persistent growth is typically driven by innovation or technological disruption, the drivers are rarely, if ever, predictable or static. In the course of our fundamental research, we have observed two distinct types of growth companies: emerging growers and stable growth compounders.

Although both groups consist of growth stocks, the differences in their characteristics and performance can be profound (Exhibit 2). In the first half of this paper, we examine the risk and return patterns of both groups across a range of market scenarios, especially during periods of high volatility. This analysis offers several critical insights into the challenges and opportunities of growth investing over the long term. In the second half of the paper, we illustrate one of our most important tenets: the irreplaceable role of fundamental, bottom-up analysis conducted by skilled and experienced active growth managers.

Emerging Growers and Stable Growth Compounders

Emerging growers are typically young disruptors, in a new or developing industry, and offer significant upside potential. To fuel their rapid growth, these companies reinvest their cash flow into sales, marketing, research, product development, and achieving scale, while reporting relatively low—or no—profits. These strategic decisions can depress margins and earnings over the short term (usually 1–2 years), but this is typically followed by a phase of pronounced growth over the following 3–5 years. Emerging growers have been concentrated in many different industries over the past several decades. In the 1980s, they were found among pharmaceutical and biotech firms; in the 1990s, they were computer hardware and internet companies; today, many are concentrated in technology software and services.

Exhibit 2: Emerging Growers Generally Have More Growth Potential than Stable Growth Compounders



For illustrative purposes only.
Source: Jennison

Stable growth compounders also demonstrate above-average growth potential, but they have a history of profitability and established drivers of growth. They are often former emerging growers that have matured into large or mega cap companies with a flourishing mix of products and services. They can maintain their competitive position through continued innovation and expansion into new markets or by leveraging an established business that cannot be easily replicated by competitors. Stable growth compounders can be found in a range of industries, including technology, luxury goods and high-end brands, and healthcare.

The differences between these two groups impact their performance. Emerging growers have longer duration profiles[4] and can be relatively volatile. They also tend to be more sensitive to market uncertainty because they have little history of reported earnings. Traditional valuation measures that are earnings-based, such as price-to-earnings, can make them appear unattractive, especially in their early years. Due to their longer duration profiles, emerging growers also tend to underperform in a rising rate environment as investors apply a higher discount to future cash flows. However, in periods of stable economic growth and flat or declining interest rates, emerging growers are usually among the market leaders.

Stable growth compounders, on the other hand, typically have shorter duration profiles and can be less volatile, as their profits are usually more visible and their sources of growth more established or diverse. This can lead stable growth compounders to outperform emerging growers during periods of economic uncertainty, but their long-term upside potential tends to be lower.

To further explore our observations of emerging grower versus stable growth compounder behavior, we applied an empirical lens to the global and US equity universes (as measured by the MSCI ACWI and the S&P 500 Index). We created proxies for the two groups by screening each index based on realized revenue and earnings growth levels (Exhibit 3).

Our parameters for emerging growers were 3-year trailing revenue growth rates above 15% and 5-year trailing earnings per share (EPS) growth rates above 20%. For stable growth compounders, we set lower thresholds, with revenue growth rates of 7%–15% and EPS growth rates between 10%–20%.

These revenue and earnings screens are a simplification. They serve as a useful way to aggregate and analyze two groups of growth companies that possess attributes that we believe will allow them to generate strong returns for shareholders. For the purposes of this analysis, our focus has been on companies that have reported positive earnings for most of the previous five years and have been growing in the ranges specified above. However, there are many high-growth companies that have not yet reported profits on a consistent basis, and some of these may offer compelling investment opportunities. Consequently, we do not rely on these screens in our own investment process, which is driven by fundamental, bottom-up analysis and a forward-looking view.

Exhibit 3: Creating Proxies for Growth Companies

MSCI All Country World Index and S&P 500 Index

	Emerging Growers	Stable Growth Compounders
EPS Growth (5-Year Trailing)	20%+	10%-20%
Revenue Growth (3-Year Trailing)	15%+	7%-15%

Source: Jennison

Insights from Our Performance Analysis

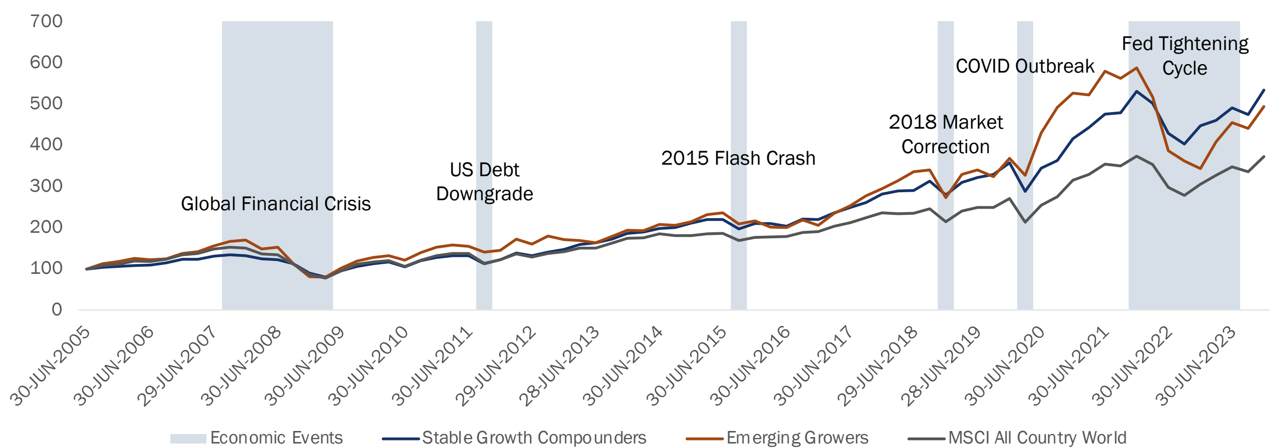
We calculated each group's performance compared to the index, from June 2005 through December 2023 (Exhibit 4). Overall, both outperformed the MSCI ACWI during this time period. Stable growth compounders led, gaining 9.5% on an annualized basis compared to 9.0% by emerging growers and 7.4% by the index. The S&P 500 Index tells a different story. Due in part to the index's heavier exposure to tech companies, emerging growers led stable growth compounders 12.4% versus 11.5%, respectively, compared to the index's return of 10.0%.

These growth stocks set a positive trajectory over time, but their paths are not perfectly linear. To gain more perspective on the performance of the two groups during periods of uncertainty, we identified six peaks in market volatility and the events that coincided with them: the global financial crisis (GFC), US debt downgrade (2011), flash crash (2015), market correction (2018), COVID-19 outbreak, and the Fed interest rate tightening cycle (2021–2023). These market events included major credit defaults, sudden panics, technical trading events, and pandemic and macroeconomic pressures. This allowed us to examine growth equity performance across different settings—with the common thread being that they each represented high volatility, tail-risk scenarios.

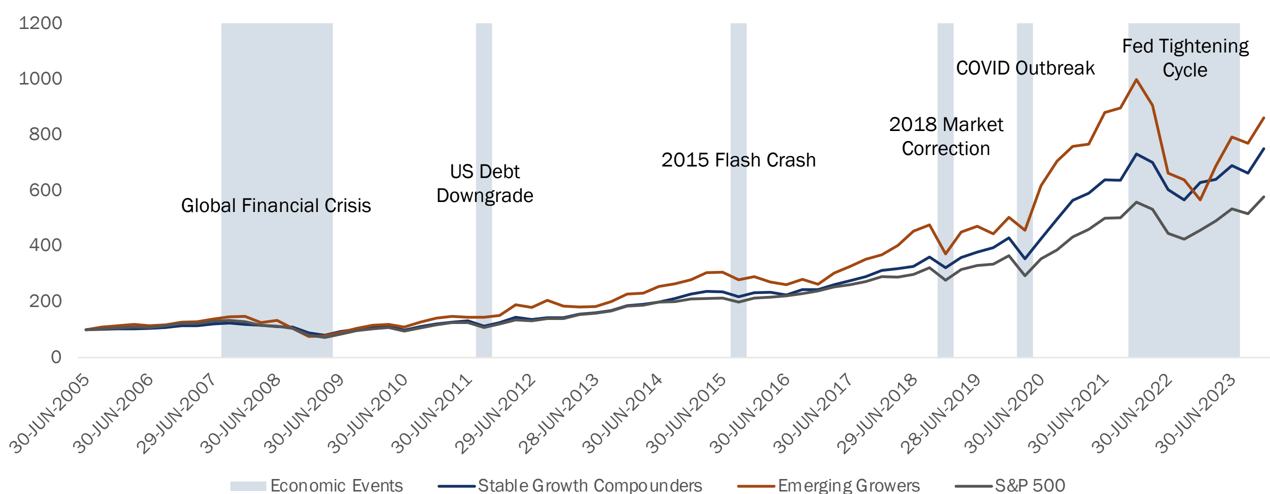
In these volatile environments, stable growth compounders globally outperformed emerging growers in each period except for the US debt downgrade and the COVID-19 outbreak (Exhibit 5).

Exhibit 4: Emerging Growers and Stable Growth Compounders Have Outpaced the Index Since 2005

ACWI, June 30, 2005 = 100



S&P 500 Index, June 30, 2005 = 100



Data from June 30, 2005 through December 31, 2023. Calculated quarterly. Past performance does not guarantee future results.
Source: FactSet, Jennison

Exhibit 5: Stable Growth Compounder versus Emerging Grower Performance in Periods of High Volatility

Event	Date(s)	ACWI Return Differential* (stable growth compounders less emerging growers)	S&P 500 Return Differential* (stable growth compounders less emerging growers)
Global Financial Crisis (GFC)	October 2007–March 2009	9.58**	9.98**
US Debt Downgrade	August 2011	-5.15	-14.01
2015 Flash Crash	August 2015	1.26	1.58
2018 Market Correction	December 2018	8.89	11.25
COVID-19 Outbreak	February–March 2020	-8.52	-8.42
Fed Tightening Cycle	January 2022–July 2023	14.88	14.98

*Stable growth compounders less emerging growers. **Annualized returns for GFC; all other returns are cumulative.
Data as of December 31, 2023. Past performance does not guarantee future results.
Source: FactSet, Jennison

The outperformance, however, did not last beyond relatively short periods of market instability, which suggests that there could be more sensitivity of returns for stable growth compounders in a prolonged macro event, such as the GFC.

The divergence in returns between emerging growers and stable growth compounders became significant during and after the COVID-19 outbreak (Exhibit 6). After March 2020, emerging growers outperformed stable growth compounders and the broad market by 12 and 11 percentage points, respectively, over the next five quarters. However, this performance reversed during the Fed tightening cycle, when emerging growers underperformed stable growth compounders and the broad market. Both groups benefited from the surge in technology adoption during the COVID-19 shutdowns, but emerging growers were more exposed to the Fed's tightening cycle and rising interest rates. When the Fed's tightening cycle neared an end, ACWI emerging growers made up ground against their stable growth compounders counterparts. It is notable that US equities show a different pattern. In their case, US emerging growers fell below stable growth compounders as the Fed tightened rates, but this decline came from a much higher peak, enabling emerging growers to recover more quickly and rise to near parity with stable growth compounders by the end of the period.

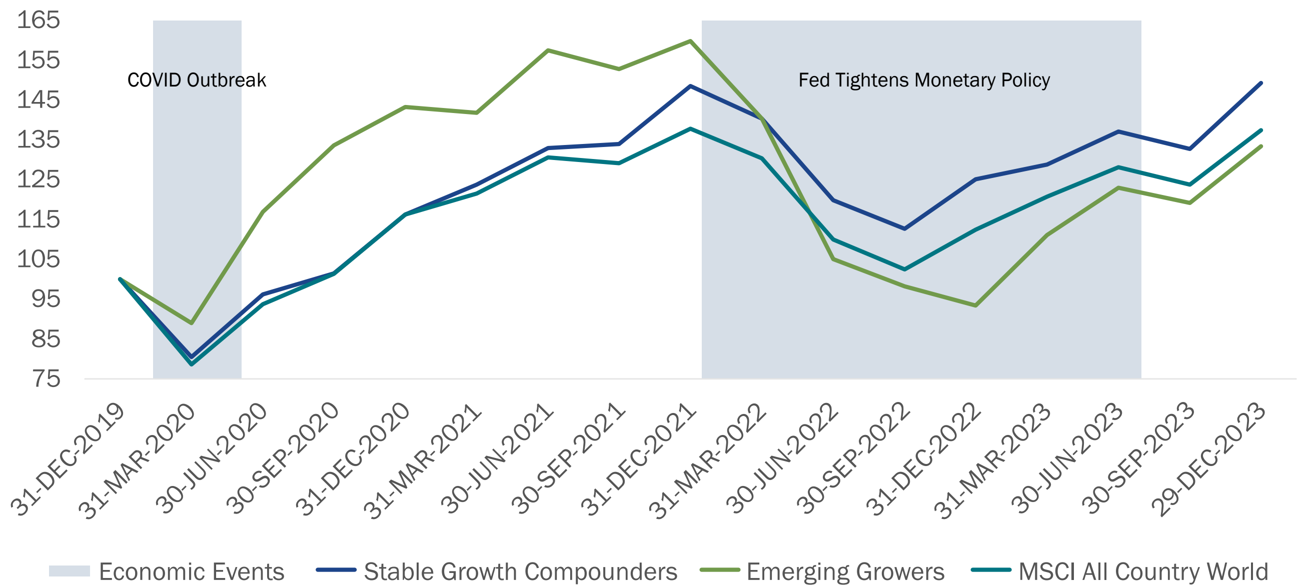
We also compared the risk and return profiles of emerging growers versus stable growth compounders on a rolling 3-year basis. ACWI emerging growers and stable growth compounders generally outperformed the index, but with some important nuances. Emerging growers generated the highest excess returns from mid-2011 to about mid-2013, and since mid-2017 until the sell-off in 2022 (Exhibit 7). Notably, stable growth compounders led performance for several years, from early 2013 to mid-2017. Moreover, while emerging growers occasionally lagged the broad markets, stable growth compounders have outperformed the benchmark since early 2012. The pattern of US large cap companies was similar.

We also calculated the volatility of emerging growers and stable growth compounders over the same time period (Exhibit 8). The higher volatility of emerging growers compared to the index and stable growth compounders is in line with their higher growth, longer duration profile. However, stable growth compounders have often exhibited lower volatility than the broad market, except for 2015 through early 2019.

Our analysis shows that emerging grower and stable growth compounder performance outcomes are mostly consistent with the characteristics of the underlying companies in the two groups. Emerging growers tend to have more dynamic long-term growth potential but are more volatile; stable growth compounders are more established and less volatile. While each group had different risk and return profiles, both outperformed the index over time.

Exhibit 6: Emerging Growers Outperformed after the COVID-19 Outbreak but Lagged When the Fed Tightened Monetary Policy

ACWI, December 31, 2019 = 100

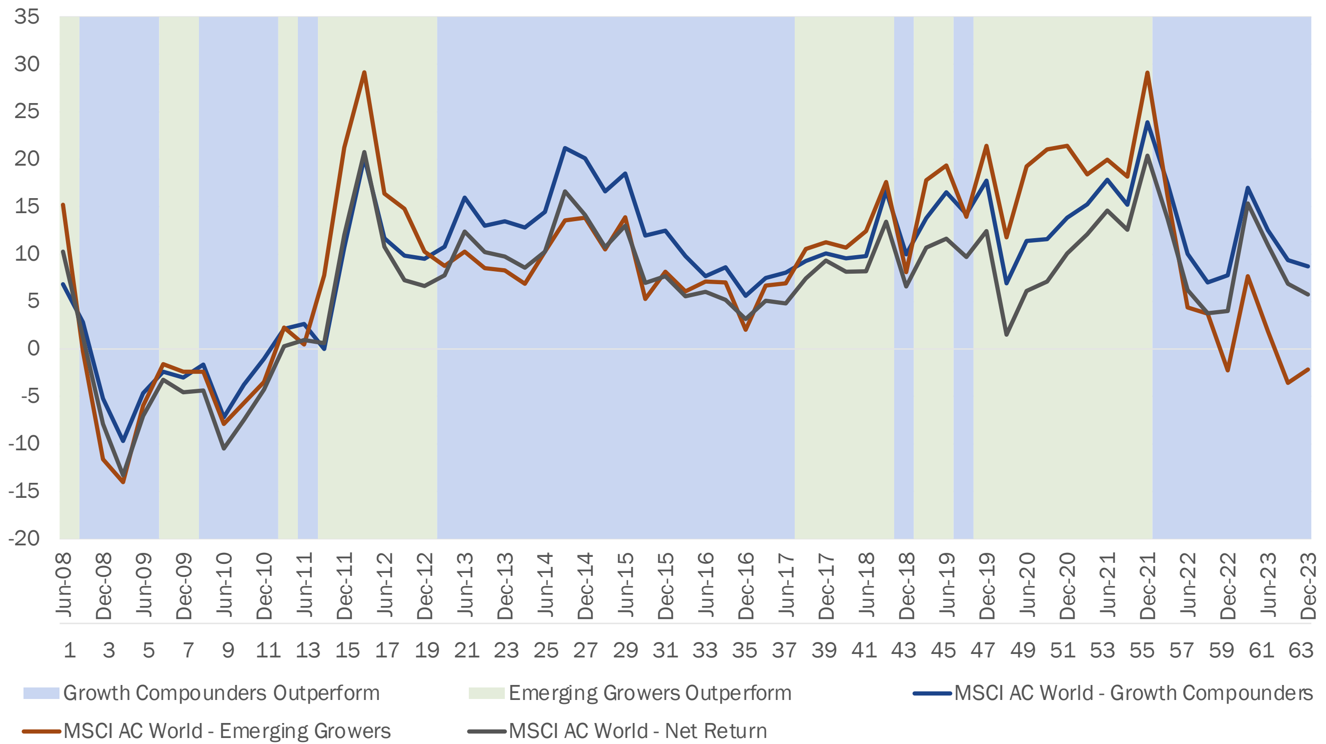


S&P 500 Index, December 31, 2019 = 100

Data from December 31, 2019 to December 31, 2023. Calculated quarterly. Past performance does not guarantee future results.
Source: FactSet, Jennison

Exhibit 7: Emerging Growers and Stable Growth Compounders Have Alternated Performance Leadership

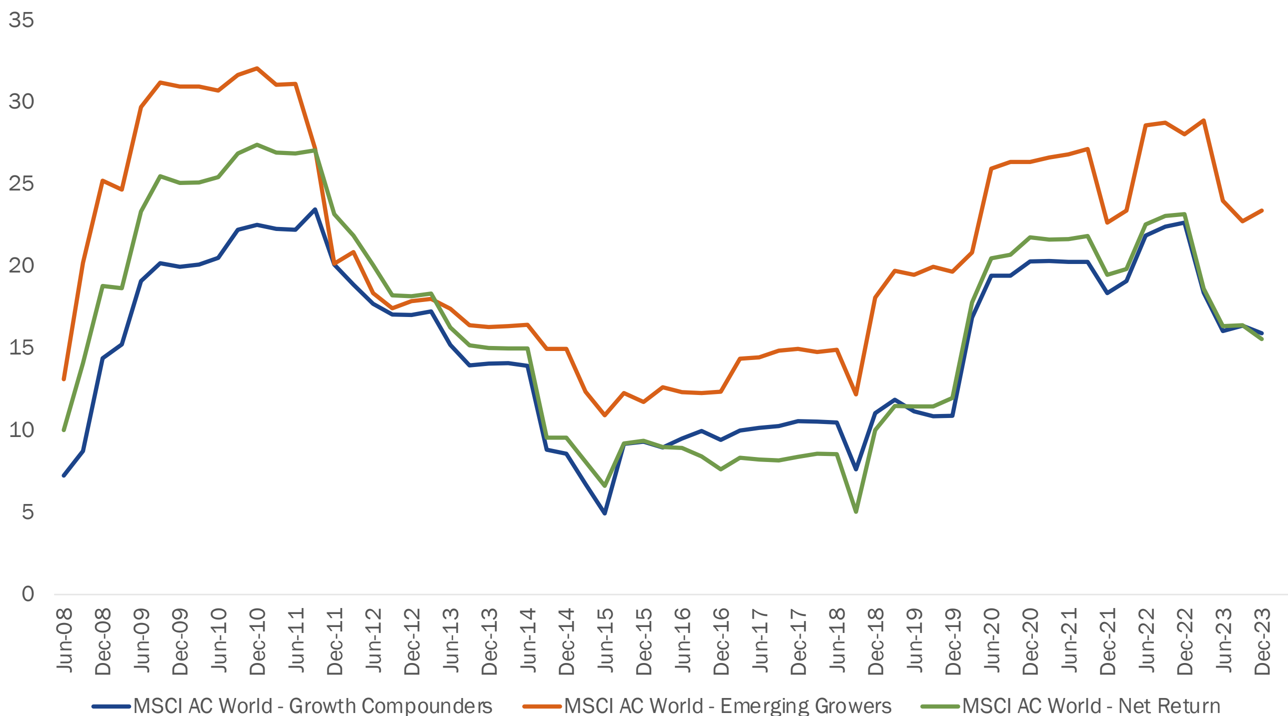
ACWI Rolling 3-Year Annualized Return (%)



Data from June 30, 2005 through December 31, 2023. Calculated quarterly. Past performance does not guarantee future results.
Source: FactSet, Jennison

Exhibit 8: Stable Growth Compounders Performed at Lower Levels of Risk than Emerging Growers

ACWI Rolling 3-Year Annualized Standard Deviation (%)



Data from June 30, 2005 through December 31, 2023. Calculated quarterly. Past performance does not guarantee future results.
Source: FactSet, Jennisonn

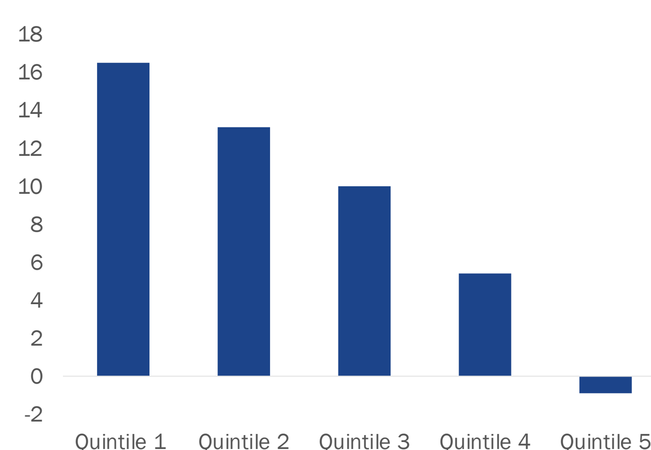
In our view, these patterns of performance tie back to the fact that markets are discounting mechanisms that reward visibility. To generate excess market returns, we believe growth investors must be earlier and more accurate than the market in identifying companies with a clear path to profitability and inflection points in the growth rates of their revenue and earnings. Earnings growth has been a potent driver of returns, and we will examine this concept and the opportunity and challenges inherent in picking winning growth stocks.

Returns Have Tracked Earnings Growth

Over the past several decades, the companies with the fastest earnings growth have outperformed through a range of market environments (Exhibit 9).

Exhibit 9: The Fastest Growers Have Outperformed over the Long Term

ACWI Performance by Historical 5-Year Earnings Growth Quintile



Data based on rolling 5-year returns for periods from 12/31/97 to 12/31/23. Source: Jennison, FactSet. Average median annualized returns of stocks over rolling five-year periods, ranked by 5-year historical earnings growth quintiles. (1=highest, 5=lowest). Quintiles are rebalanced quarterly. Past performance does not guarantee future results.

We mapped each company in the emerging growers and stable growth compounders proxy portfolios to the corresponding performance quintile, to test our hypothesis that they should be concentrated in the first two quintiles of returns. The results were in line with our expectations. The vast majority of emerging growers were concentrated in the top quintile of returns, which is an intuitive result as these companies are in the highest ranks of 5-year earnings growth. Stable growth compounders tended to cluster in the second quintile of returns, with some falling into the third quintile. This is also consistent with the levels of earnings growth generated by these companies.

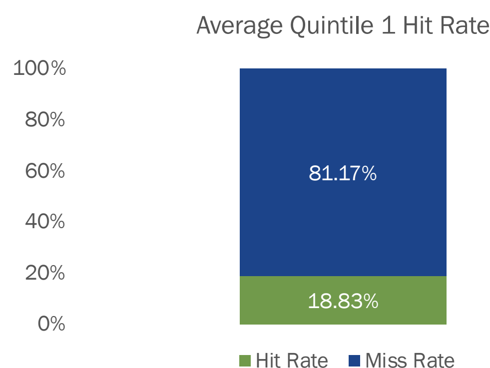
While long-term data shows that the top earnings growers lead performance, this trend reversed in the 12 months through September 30, 2022. Investors, facing the uncertainty of a step change in inflation and interest rates, sold the high growers ostensibly for the perceived safety of shorter-duration growth stocks.

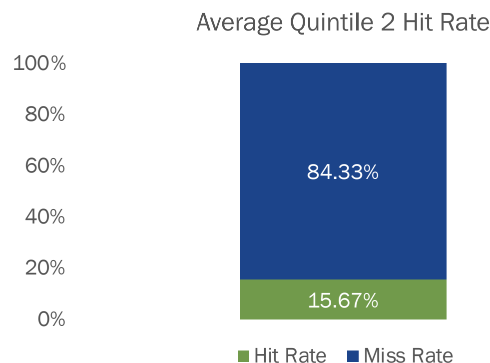
Successful Growth Investing Is an Active Challenge

Putting aside the reversal in returns over that time period, Exhibit 9 might suggest a strategy for successful long-term growth investing: simply construct a portfolio of stocks from quintiles 1 and 2. It should come as little surprise, however, that the reality is far more complex. Identifying in advance the companies that will deliver high and sustainable growth is extremely difficult. As a case in point, the vast majority of companies fail to live up to consensus growth expectations in both the MSCI ACWI and the S&P 500 Index (Exhibit 10).

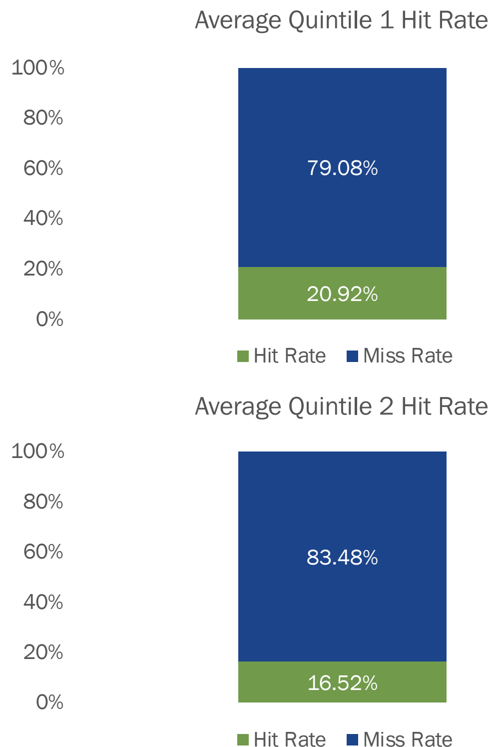
Exhibit 10: It's Very Difficult to Identify Top Performers in Advance

ACWI





S&P 500 Index



ACWI and S&P 500 Index data from June 2005 through December 2023. Companies with expected top quintile EPS growth (according to consensus) contrasted with the actual constituents of those quintiles five years later. Companies that met earnings expectations are "hits;" companies that did not meet expectations are "misses."
Source: Jennison, FactSet.

We mapped companies into quintiles 1 and 2 according to consensus earnings growth expectations and then contrasted the results with the actual constituents of those quintiles five years later. The result? Less than one fifth of the companies that consensus estimates placed in quintile 1 (mostly emerging growers) met the mark. In quintile 2, the numbers were even worse—about 15% lived up to consensus expectations five years later. When we focus on US companies, the hit/miss rate is slightly higher but supports our conclusion. This data shows that, most of the time, consensus earnings growth forecasts have been either too optimistic or too pessimistic. It also illustrates the market's inefficiency and the potential benefits of having an experienced research function wholly focused on appraising growth opportunities via fundamental company research. Even small improvements in forecasting, in our view, can add significantly to long-term returns.

Another example of the challenges of growth investing can be found in the way companies report earnings, the strength of which can be understated by evolving business models and conventional revenue recognition methods. In some cases, employing a different methodology—one that draws on measures such as free cashflow or enterprise value—can reveal underlying strength in a company's valuation. This helps illustrate that successful growth investing can require active managers with the skill, experience, and resources to spot these irregularities and take advantage of them.

To learn more about the challenges of building an outperforming growth portfolio based on consensus earnings, read our infographic.

Navigating for the Long Term

We maintain a long-term perspective on investing despite market uncertainty and volatility. Growth companies that offer differentiated products and services that create real value for society will continue to prosper, in our experience. While demand may be uneven in the short term, the long-term trend is typically positive.

As investors look for companies that will generate sustainable growth, we believe they can benefit from a deep understanding of the differences within the spectrum of growth equities—especially emerging growers and stable growth compounders. As we have demonstrated, companies from these two groups have compelling long-term return potential, but also distinct risk and return profiles. Over the shorter term, their performance can vary, especially against changing market backdrops. An understanding of these differences can help investors navigate market cycles as growth comes into, and goes out of, favor.

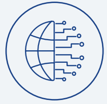
We share this aggregated analysis as a framework for growth investing, but we also emphasize our belief that success lies in the basic building blocks of fundamental security selection, which, when done well and consistently by a skilled active manager, meaningfully contributes to a long-term investment goal. This is a challenging proposition, but one that history demonstrates can be achievable and, above all, rewarding.

Secular Themes as a Wellspring of Growth

Secular growth themes, in our view, can provide significant tailwinds to well-managed companies. We have identified several themes:

Fintech

An opportunity in emerging markets as businesses, organizations, and individuals continue to find new ways to gain more convenient and more affordable access to financial services.



Artificial Intelligence

We are in the opening stages of a generative AI–driven investment cycle that we believe will sweep through the technology sector and, ultimately, the economy.

Luxury

Despite economic and market uncertainty, top luxury brands have been flourishing and exploiting direct to consumer innovations.

Healthcare Innovation

Healthcare companies are finding significant opportunities in drug development, personalized treatment, and data analysis.

Industrial Automation

Technology-enabled changes in industrial automation can lead to enormous productivity gains.

Endnotes

[1] Based on MSCI All Country World Index and the S&P 500 Index 5-year rolling returns from 1992-2023. See Exhibit 9.

[2] For this analysis we used company data going to back to 2005, the first year in our view with enough data to ensure thorough and meaningful analysis. In addition, we sought 19 years of data (versus a more standardized 15 year period) to have enough context for the Global Financial Crisis in 2008–2009.

[3] Revenue growth based on 3-year historical revenue growth and earnings growth based on 5-year historical EPS Growth (equivalent to 716 of an average of 2,642 companies in the MSCI ACWI from June 2005 through December 2023). When we raise the growth threshold to 15% based on 3-year historical revenue growth, and 20% based on 5-year historical EPS Growth, this proportion shrinks to about a tenth of the index (or 11%, equivalent to 288 companies).

[4] Long-duration growth companies, in this context, have the bulk of their expected profits weighted towards more distant time periods. Conversely, short-duration companies are expected to report a more significant share of their future profits in the near term.

[5] These thresholds are not intended to be definitive; we believe they should be adjusted should levels of growth structurally reset over time.

Disclosures

Published May 2024.

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2024-3482643

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