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INVESTMENT MANAGERS

Great Expectations

The Outlook for Quality Growth Investing is Suddenly Improving

The unusual period of easy money appears to be drawing to a close. Tighter monetary conditions are not yet showing up in rising interest rates, but they are showing up in rising credit spreads and a sharp deterioration in the market for initial public offerings (IPOs). The near decade long headwinds experienced by quality growth investors are likely over.

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Mr. Hackney joined Atlanta Capital in 1995 and is responsible for providing economic and investment research to the firm. Prior to joining Atlanta Capital, he was Senior Vice President and Chief Investment Officer of First Union Corporation's Capital Management Group in Charlotte, North Carolina. In this capacity he supervised the investment management of over $20 billion in institutional and individual assets.

Mr. Hackney is a graduate of The University of North Carolina at Chapel Hill and holds an MBA degree from The Citadel in Charleston, South Carolina. He served as a U.S. Marine Corps officer during the Vietnam Era and retired with the rank of Colonel in the U.S. Marine Corps Reserve. Mr. Hackney holds the Chartered Financial Analyst designation.

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The Outlook for Quality Growth Investing is Suddenly Improving

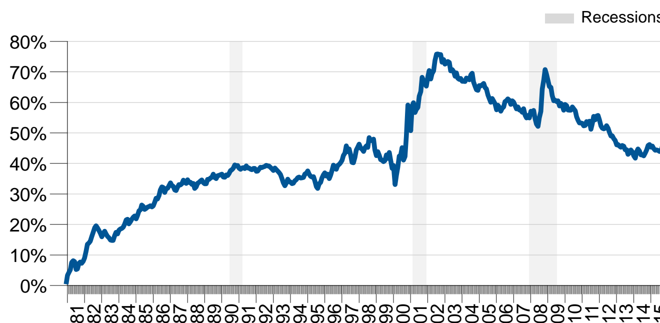
Executive Summary

- We believe the relative performance of quality growth stocks should improve in 2016 regardless of the general direction of stock prices.
- Over the past eight years, investors have experienced an unprecedented period of easy money. Easy money tends to benefit lower quality, less seasoned, more speculative companies.
- This unusual period of easy money appears to be drawing to a close. Tighter monetary conditions are showing up in rising credit spreads and a sharp deterioration in the market for IPOs.
- Our research shows that the performance of the quality growth investment style is closely tied to credit market conditions. Quality usually begins to outperform somewhere between six and twelve months after the commencement of a Fed tightening cycle and continues to outperform for another two years or so.
- Credit spreads and the health of the IPO market can be important explanatory variables in assessing the outlook for quality growth performance. Widening credit spreads and a deteriorating IPO market usually indicate tightening monetary conditions. When this is the case, high-quality growth stocks typically outperform their benchmark.

Charles Dickens' classic novel *Great Expectations* depicts the life journey of an orphan nicknamed Pip in 19th century England. It is an often harrowing tale of life and death, wealth and poverty, love and rejection and ultimately the triumph of good over evil. The novel is a fitting analogy to the trials and tribulations of high-quality growth investing over the past decade or so.

Exhibit 1 shows the performance of high-quality growth stocks, as measured by our Quality Growth Research Portfolio*, over the last 35 years. From 1981 to 2002, Quality Growth generally outperformed the Russell 1000® Growth index. Since 2003 Quality Growth generally underperformed its Russell benchmark. Quality Growth's strong outperformance in the market crash of 2008, followed by lackluster performance in the ensuing bull market, gave rise to the notion that Quality Growth was just a "foul weather friend," capable of good performance only in a bad market environment. But, Quality Growth's strong performance during the great bull market of the 1980s and 1990s demonstrates that high-quality can be a positive contributor to performance in both rising and falling stock markets.

Exhibit 1: Cumulative Relative Return Quality Growth Research Portfolio vs. Russell 1000® Growth Index



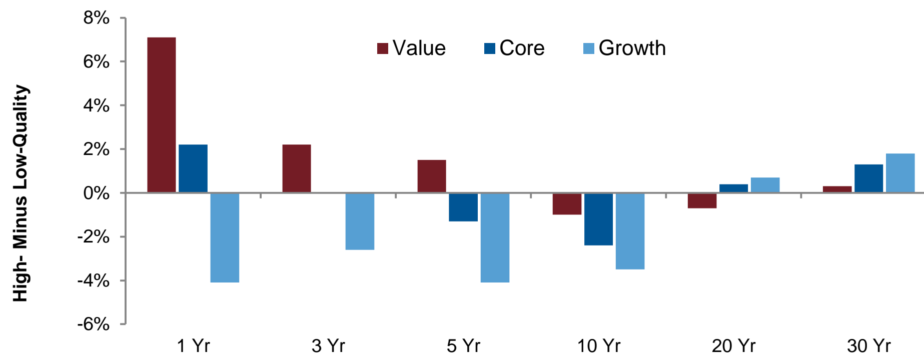
Annualized Returns (%)

	'80s	'90s	'00s	'10s*
Quality Growth Portfolio	15.3	18.7	(0.2)	12.1
Russell 1000® Growth Index	11.6	17.3	0.0	13.5

*2011-2015.

**The Quality Growth Research Portfolio: the model portfolio is compiled by Atlanta Capital and is comprised of all stocks within the Russell 1000® Growth index which are ranked B+ or better by the Standard & Poor's Earnings & Dividend Ranking system. At year-end 2015, the research portfolio was comprised of 339 companies representing 65% of the market capitalization of the Russell 1000® Growth index. Sources: Standard & Poor's, Russell, Wilshire Atlas, Atlanta Capital as of 12/31/15.*

Exhibit 2: Quality Differential by Investment Style
Periods Ending December 31, 2015



Sources: Standard & Poor's, Russell, Wilshire Atlas, Atlanta Capital as of 12/31/15. Quality differentials represented by Russell 1000® Value (Value), Russell 1000® (Core), and Russell 1000® Growth (Growth) indexes.

Exhibit 2 shows the performance of high-quality less low-quality stocks for the three major large capitalization style groups—value, core and growth. Note that high-quality stocks within the growth style have delivered the strongest relative outperformance over the last twenty- and thirty-year periods. However, quality has been a significant detriment to growth style performance for the past one-, three-, five- and ten-year periods. Also note, quality provided a boost to performance for the value and core styles for 2015, but did not provide a boost for the growth style.

From the data in Exhibits 1 and 2, it appears that high-quality investing has not worked as well for growth style investors as for value or core investors, at least not over the last decade.

Why is this the case? In our opinion there are two interrelated reasons. First are the differences in the economic sector composition of the value, core and growth indexes. In contrast to core and growth, the value index tends to be dominated by more economically sensitive sectors such as energy, materials and industrials. Much of the last five years has been characterized by an economic environment of lackluster global growth and severe downward pressure on industrial commodity prices. Indeed, the general widening of credit spreads over the last 18 months (see Exhibit 5) has been sparked by a sharp deterioration in the high yield debt market for energy and basic materials companies.

The Standard & Poor's (S&P) Earnings & Dividend Rankings, commonly known as quality rankings for common stocks, reward steady and consistent earnings growth and penalize earnings volatility. Thus it is not surprising that quality has provided a bigger performance boost to the value style than the other two over the past five years. Deteriorating credit market conditions hit the value style first, so the benefits of quality showed up in the value index well ahead of the core and growth indexes.

The second reason that Quality Growth has lagged the relative performance of the other two styles relates to the pace of technological change and innovation. Extraordinarily low interest rates and "easy money" conditions in recent years helped spark an initial public offering (IPO) boom, particularly in the internet services and biotechnology industries—two of the "growthiest" sectors of the stock market. (Low interest rates tend to raise the present value of a discounted stream of future earnings. Hence a low rate environment is good for getting top valuations for growth stocks).

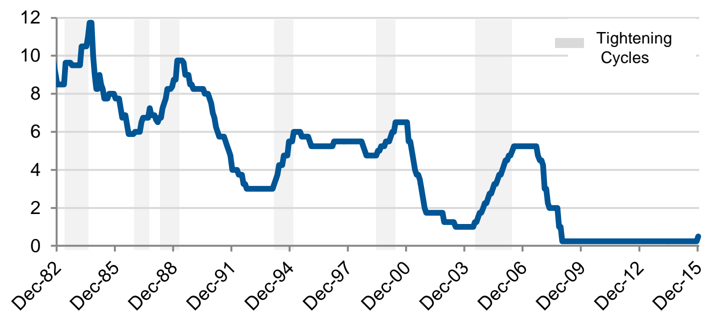
A booming IPO market results in a lot of new technology and health care companies that eventually find their way into the growth style indexes. It's important to realize, however, that many of the more speculative growth companies are as dependent on the IPO market as speculative companies in other economic sectors are dependent on the junk bond market. So, a booming IPO market and booming junk bond market go hand in hand. Both are the result of easy monetary conditions and both create headwinds for high-quality oriented investors, particularly growth managers who use the S&P Earnings & Dividend Rankings. Since S&P requires a minimum of 40 quarters of earnings in order to receive a quality score of A+ through D, many of the newer, more speculative growth companies don't yet have an S&P Quality Ranking. The strong performance of several "non-ranked" growth companies in 2015 was a major reason that the high-quality attribute did not work for the growth style last year.

Exhibit 3: Fed Rate Hike Cycles

Tightening Cycle		Fed Funds Rate			Duration
Start	End	Start	End	Increase	# Months
May 83	Aug 84	8.50	11.75	+3.25	16
Dec 86	Sep 87	5.875	7.250	+1.375	9
Mar 88	Feb 89	6.50	9.75	+3.25	11
Feb 94	Feb 95	3.00	6.00	+3.00	12
Jun 99	May 00	4.75	6.50	+1.75	11
Jun 04	Jun 06	1.00	5.25	+4.25	24

Source: Bloomberg.

Fed Funds Target Rate (%)



Source: Baseline.

So is now a good time to abandon high-quality growth stocks in favor of newer and less seasoned companies? Probably not. The same situation existed in 1999 in the run up to the dotcom bust of 2000. Lower quality, higher price/earnings multiple, less seasoned companies were leading the market. And it all ended badly about a year after the Fed began tightening monetary policy in mid-1999 and the IPO market collapse of 2000-2003.

We are not suggesting that the stock market is on the brink of a severe bear market like 2000-2002 or 2008. We are suggesting, however, that credit market conditions are becoming less favorable and that this is a reliable leading indicator of better relative performance of the quality growth style. In fact, in January 2016, our quality indicators for all equity style and capitalization categories turned positive.

Exhibit 3 shows data featuring the last six Federal Reserve tightening cycles. We define a tightening cycle as beginning with the date of the first hike in the federal funds rate, following a period of flat to declining rates. We define the end of a tightening cycle as the date of the last fed funds rate hike which precedes an eventual rate cut.

Exhibit 4 shows the performance of our Quality Growth Research Portfolio before and after the commencement of a tightening cycle. The data show that quality usually begins to outperform somewhere between six and twelve months after the commencement of a Fed tightening cycle and continues to outperform for another two years or so. This pattern of outperformance occurred in every tightening cycle, except the June 2004-June 2006 cycle.

What caused this exception? As it turns out, not every tightening cycle is created equal. The severity of a tightening cycle can be measured by the change in credit spreads; i.e., the difference in yields between high-quality bonds (Treasuries) and low-quality bonds (high yield or junk bonds).

Exhibit 4: Excess Returns (%) Before and After Fed Tightening Cycles
Quality Growth Research Portfolio vs. Russell 1000® Growth Index

Tightening Start Date	6 Months Prior	6 Months After	12 Months After	24 Months After*	36 Months After*
May 83	-1.95	+1.16	+3.05	+4.64	+4.35
Dec 86	+1.81	-0.72	+1.37	+1.06	+1.21
Mar 88	+0.31	-0.01	+0.81	+0.73	+1.39
Feb 94	-0.92	+1.21	+2.85	+1.37	+2.15
Jun 99	-2.97	-1.92	+1.79	+5.50	+6.15
Jun 04	-0.25	-2.16	-1.81	-2.80	-2.20

*Periods greater than 12 months are annualized. Source: Standard & Poor's, Russell, Wilshire Atlas, Atlanta Capital.

Exhibit 5 shows the trend in credit spreads since the 1980s. Rising credit spreads mean that lenders are becoming more risk-averse and the availability of credit is deteriorating. Rising credit spreads accompanied by rising interest rates usually spells trouble ahead for both the stock market and the economy.

In the tightening cycles of 1988-1989 and 1999-2000, credit spreads rose sharply before Fed tightening began and continued to rise after Fed tightening commenced. Each of these credit cycles were severe and resulted in an eventual recession.

The tightening cycles of 1994-1995 and 2004-2006 were rather mild by comparison. In each case, credit spreads were falling well before the Fed's first rate hike and continued to fall over the next 36 months. There was no recession following the 1994-1995 tightening cycle. Of course, a severe recession did follow the 2004-2006 tightening cycle, but it occurred with a significant lag—three and a half years after the tightening cycle began. Credit spreads did not begin to widen until the summer of 2007, about 36 months after the tightening cycle began and six months before the beginning of the 2008-2009 recession.

As credit spreads continued to widen in the early months of 2008, Quality Growth began to outperform its Russell benchmark and turned in strong relative returns in the bear market year of 2008.

So, what are the credit market tea leaves saying about the prospects for Quality Growth in 2016? On the surface, it looks like the Fed has embarked on a modest tightening cycle with the 25 basis point (0.25%) hike in the federal funds rate last December. Because of the weakness in China and other emerging market economies as well as the crash in industrial commodity prices, many analysts are arguing that the Fed will be slow to raise rates further during 2016. While this may indeed be the case, trends in credit spreads are suggesting that monetary policy is already a lot tighter than a 0.25% federal funds rate would imply.

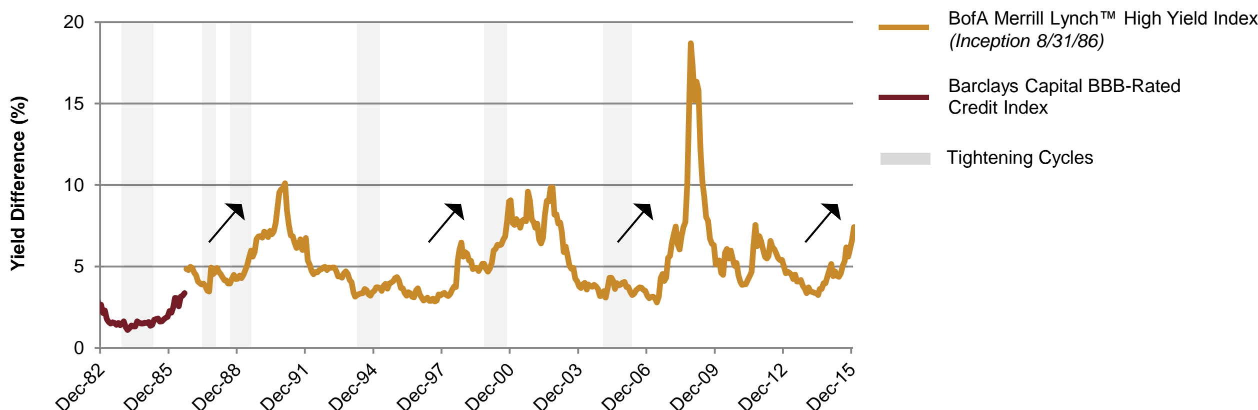
Exhibit 5 shows that credit spreads hit a low in the summer of 2014 and have been steadily widening ever since. In June 2014 (about the time that the US dollar began to strengthen and oil prices began to fall), average junk bond yields were 325 basis points (3.25%) over US Treasuries. Today the spread is 740 basis points. Much of the recent trouble in the junk bond market has been concentrated in the energy and basic materials sectors. But there's a growing concern that deteriorating credit conditions may spread to other sectors of the economy. Just like the subprime lending crisis spread to other areas of the economy in 2007 and 2008.

In our view, credit market conditions are tight enough today to boost the relative performance of high-quality stocks across the style and capitalization spectrums. The performance of quality during January helps confirm our convictions.

During the past ten years, investors have experienced an unprecedented period of easy money characterized by near zero short-term interest rates and several bouts of quantitative easing (QE). Easy money tends to benefit lower quality, less seasoned, more speculative companies which are more dependent on the capital markets to finance their operations. As a result, higher quality companies have often lagged their respective benchmarks.

We believe this unusual period of easy money is now drawing to a close. Tighter monetary conditions are not yet showing up in rising interest rates, but they are showing up in rising credit spreads and a sharp deterioration in the market for IPOs. The long agony for Quality Growth investors is probably over. A little performance ecstasy could be right around the corner…if not in an absolute sense, then perhaps in a relative one.

Exhibit 5: Credit Spreads
Yield-to-Maturity vs. 10 Year Treasury Yield



Sources: Barclays Capital, BofA Merrill Lynch™, Bloomberg.

About Atlanta Capital

Atlanta Capital Management Co., LLC is an institutional investment management firm with $16.1 billion in assets under management and 45 employees as of December 31, 2015. The firm specializes in high-quality domestic securities and invests in companies with demonstrated histories of consistent growth and stability in earnings. In fixed income, Atlanta Capital emphasizes securities with stable and predictable cash flows, and low credit and event risk.

Index Descriptions: Russell 1000® Value Index includes Russell 1000® Index stocks with lower price/book ratios and expected growth values. Russell 1000® Index includes approximately 1000 of the largest stocks of the Russell 3000® Index. Russell 1000® Growth Index includes Russell 1000® Index stocks with higher price/book ratios and forecasted growth values. The BofA Merrill Lynch™ High Yield Index tracks the performance of US dollar-denominated, non-investment grade corporate securities. The Barclays Capital BBB-Rated Credit Index consists of the BBB- component of the Barclays US Aggregate Index. Barclays Capital and BofA Merrill Lynch™ indexes not for redistribution or other uses; provided "as is," without warranties and with no liability. Atlanta Capital has prepared this report; Barclays Capital and BofA ML do not endorse it, or guarantee, review or endorse Atlanta Capital's products. Index returns do not reflect the effect of any sales charges, commissions, expenses, taxes or leverage, as applicable. Indexes are unmanaged and do not incur management fees, transaction costs or other expenses associated with managed accounts. It is not possible to directly invest in an index.

Quality Growth Research Portfolio: The Quality Growth Research Portfolio includes all companies in the Russell 1000® Growth Index with High Quality S&P Rankings (B+ or Better). The High Quality and Low Quality Growth Research Portfolios shown in Exhibit 2 on page 4 are provided to compare the aggregate of all companies in the Russell 1000® Value Index (Value), Russell 1000® Index (Core), and Russell 1000® Growth Index (Growth) with High Quality S&P Rankings (B+ or Better) to those with Low Quality S&P Rankings (B or Below and Not Rated). The universe includes all index constituents with S&P Quality Rankings and prices greater than $1. The Research Portfolios are model portfolios formed and rebalanced monthly by Atlanta Capital and are not based on investment decisions. Rates of return are calculated using a market capitalization weighted-methodology. Investment management fees, transaction costs or other expenses are not deducted from the model portfolios, and the deduction of such expenses would lower the results shown. The Research Portfolios were derived in part from the Russell Index Data. Frank Russell Company remains the source and owner of the Russell Index Data contained or reflected and all trademarks and copyrights related thereto. Sources: Russell, Standard & Poor's, Wilshire Atlas and Atlanta Capital. The material is based upon information that these sources consider reliable, but neither Russell, S&P, Wilshire nor Atlanta Capital warrants its completeness, accuracy or adequacy and it should not be relied upon as such. Performance during certain periods reflects strong stock market performance that is not typical and may not be repeated.

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