WESTFIELD
CAPITAL MANAGEMENT

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The Time for ACTIVE and Especially for GARP!

A Letter from the CEO

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Executive Summary:

- A major shift is taking place in stock market leadership
- The period of zero interest rates, slow economic growth, and disinflation is ending
- The environment going forward is ideal for GARP investing and active management

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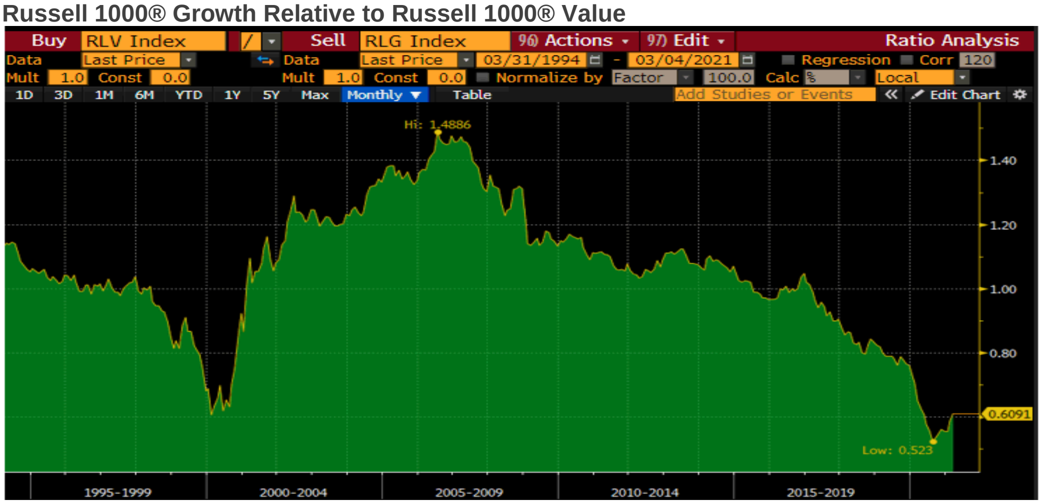
A major shift is taking place in stock market leadership. Over the last decade we have witnessed the incredible outperformance of long-duration secular growth stocks, most notably within Technology, at the expense of nearly all other investable assets. The long and slow recovery coming out of the Great Financial Crisis combined with a zero-interest-rate policy, coupled with rapid technological change created a perfect backdrop for capital to flow to a small subset of the market. Rising fund flows to cap-weighted passive index vehicles accelerated this trend and resulted in record high asset concentration amongst a select few companies. At its peak in 2020, the top 10 stocks in the S&P 500 accounted for nearly 1/3rd of the Index, surpassing the highs reached during the dot-com bubble top. The inverse of this dynamic is also true; large groups of stocks have been under allocated capital relative to their earnings prospects for years. The events of 2020 drove some of these dynamics to a breaking point where growth scarcity paired with a partial economic shutdown and a massive liquidity injection led to the outright dismissal of valuation as a material metric for many investors. We witnessed the rise of growth-at-any-price as a leading successful investment strategy. We all knew this would not end well, as rampant speculation never does. With an explosive economic recovery immediately ahead, rising interest rates, and the return of inflation, we expect P/E multiple compression, and a major mean reversion for aggressive growth and momentum stocks. We are seeing investor focus returning to tried-and-true valuation criteria like free cash flow, earnings growth, and return of capital. The recent gains of value indices relative to growth reflect this trend change and is likely just the start of a multi-year story. In this environment, Growth-At-A-Reasonable-Price as an investment strategy should be poised to substantiate its value once again to investors, as it has over the long term.

Figure 1: We expect GARP stocks to outperform relative to their momentum growth peers in an environment with value outperformance and rising interest rates. Recent gains of value stocks relative to growth stocks returns the long-term trend back only to the 2000 lows.

Russell 1000® Growth Relative to Russell 1000® Value



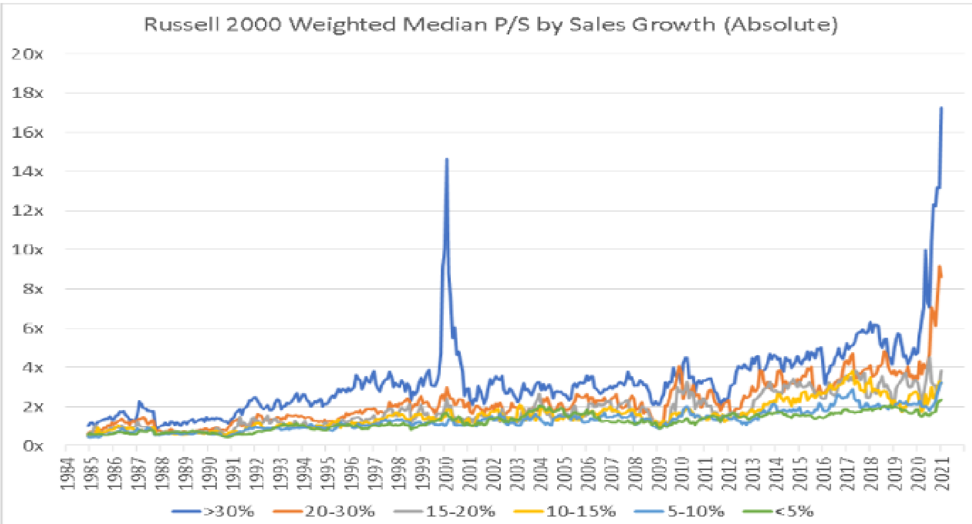
Source: Bloomberg as of 3/4/21

How did we get here?

Some of the ingredients responsible for the market narrowing around long-duration secular growth stories like an artificially low discount rate and quiescent inflation have been in place for some time, but the U.S. government's response to the Covid crisis added the accelerant needed to make obvious the relative valuation disparities present in the market. Economic shutdowns resulted in even fewer growth opportunities and the flood of liquidity, first injected to stave off a market collapse, eventually made its way into more speculative pockets of the market. Secular growth leadership gave way to dream stock leadership, completely dislodged from any rational valuation framework. We expect the momentum and speculation unwind to gather speed in the weeks and months ahead.

Figure 2: The fastest growing segments saw valuations explode higher to levels previously only seen during the heights of the dot-com euphoria.

Price to Sales Multiples based on Sales Growth

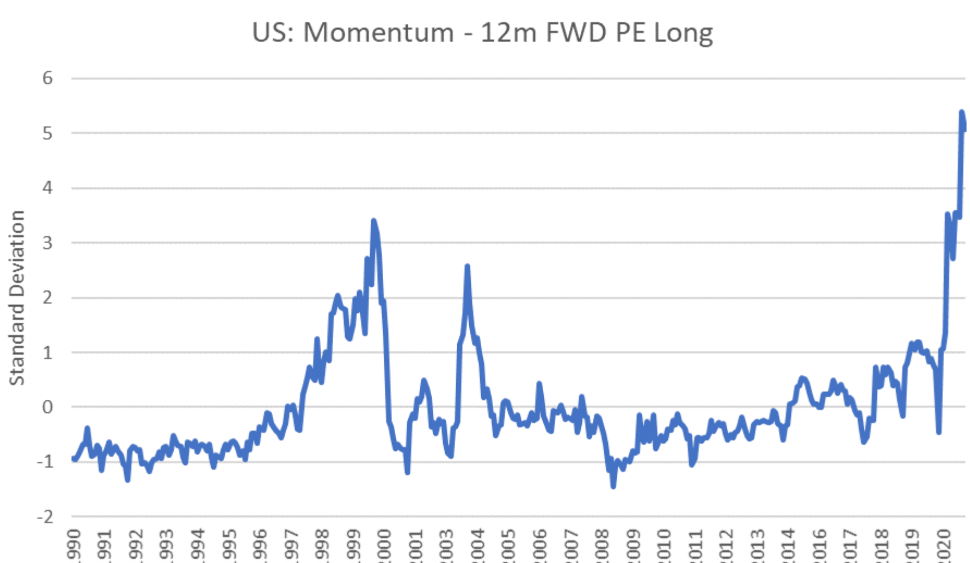


Source: Furey Research Partners, as of 2/12/21

The return of the retail investor only exacerbated the frenzy in these so-called Robinhood stocks like solar, unproven biotech, and electric vehicle makers, not to mention the SPAC craze, emergence of Non-Fungible Tokens, and massive gains in cryptocurrencies. The recent momentum in unproven story stocks that took over the market has reached a tipping point. In fact, momentum as a factor was recently trading at 5 standard deviations above its historic mean!

Figure 3: Momentum factor was recently trading at forward earnings multiples 5 standard deviations above its historic mean.

Momentum Factor Forward P/E



Source: Bloomberg as of 2/28/21

The market speculation seen over the last few months is something I have not seen in my 30-year career. I never thought the hysteria seen in the ‘99 tech bubble would ever be eclipsed, but this part of the market today is far worse, in my opinion. Tech investors were not worried in 1999 and then it took until 2012 for those investors to recoup their money. Financials investors were not worried in 2007, and those stocks took 13 years to recover. A large group of retail investors are not worried about a record number of money-losing companies issuing IPO’s or a seemingly unlimited supply of SPAC’s. This will not end well; we all know that.

What precipitated the trend change?

The convergence of an accelerating economy reopening from the Covid crisis, rising interest rates, and the expectation for a return of inflation after more than a decade in hiding is driving a major shift in market leadership and the rules by which we all will now need to invest. As interest rates rise, so too do discount rates, meaning a lower present value of future earnings and a lower stock price, all else equal. Over the last 10 years, the rate structure has collapsed and long-duration secular growers have been the biggest beneficiaries as P/E multiples for future earnings streams rose. We are now entering the perfect storm the other way and the stocks most dependent on inflated earnings multiples based on out-years growth expectations are the most exposed and have the farthest to fall. Earnings (not P/Es) will drive market leadership for the first time in years. The global economy has stimulus tailwinds which should drive strong PMI readings and with that, a high percentage of positive EPS revisions, especially for cyclical equities. We expect this re-rating to only accelerate with the reopening economy. The distribution of effective vaccines coupled with massive fiscal and monetary stimulus is likely to lead to excess money supply and an estimated 10% GDP growth during the second half of 2021. There is incredible pent up consumer demand and trillions in unintentional consumer savings waiting to be spent at bars, restaurants, and on travel and leisure. We are likely to witness a “V” rebound only comparable to what we have witnessed during a post-war economy. Shortages of labor and goods will be rampant and will only exacerbate the upward pressure on interest rates and inflation, surpassing current Wall Street expectations, in my opinion. We feel strongly that the yield on the 10-year Treasury will exceed 2.0% by the end of this year and that inflation will eclipse 3% in 2022. Based on historical precedent, aggressive growth stocks could massively underperform, similar to what happened in the wake of the dot-com bubble of 2000.

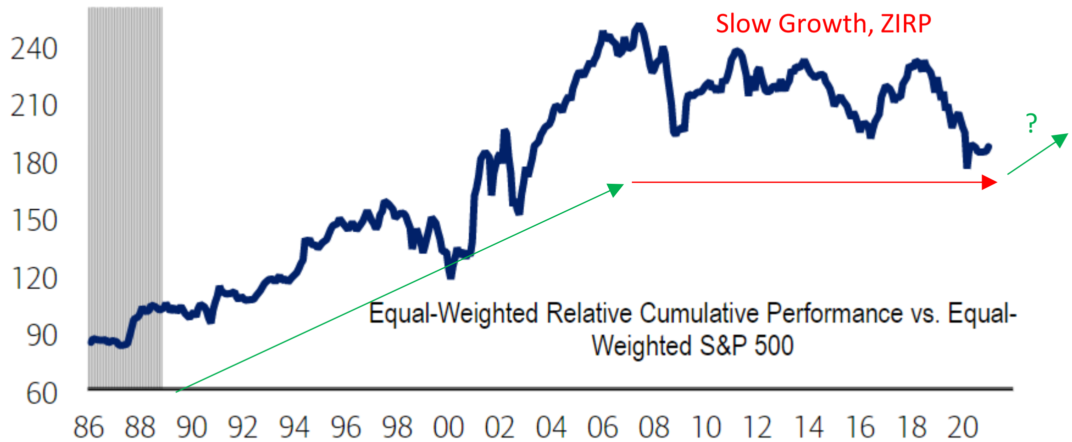
What kind of a market are we entering now?

We believe we are entering a market where a premium will be placed on earnings and valuations, where the focus exclusively on growth rates will drop in the priority list, and quality will be paramount: a market where the Growth-At-A-Reasonable-Price (GARP) investment style should thrive. Some of the market leaders from the last cycle are the most innovative technology companies with dominant franchises and advantaged business models, and we remain invested because they are reasonably priced, if not cheap, relative to history. Others, however, are trading at multiples of sales greater than 30X, levels not contemplated since the run up in 1999. These companies will not see earnings accelerate when the economy reopens, but, rather, will experience multiple compression as the discount rate increases due to rising interest rates. We believe the companies best positioned to lead in this market are those most levered to near-term earnings upside from the broadening recovery and economic acceleration. Since passive investing is inherently a momentum game based on investing in cap-weighted indices, we would expect to see them struggle relative to equal-weighted indices and active managers as momentum wanes and the recovery takes hold. In this new environment we are entering we expect to see nearly the complete inverse of what we experienced during the last market surge: the most heavily shorted, penny stocks, unprofitable, low share price, high leverage companies that led at the end of last year and into January should massively underperform and factors we put a premium on such as high ROE, low beta, quality and profitability should lead the market going forward. The unwind has already started and we are only in the first inning.

Short term aside, we expect this leadership change to have a longer lasting impact. Historically, a focus on quality and valuation has been a winning strategy with GARP stocks tending to outperform the market over long periods of time. However, this strategy has faced a headwind in an era of slow growth, unprecedented fiscal and monetary stimulus, zero interest rates, and no inflation.

Figure 4: The headwinds of low interest rates and slow growth GARP investing faced over the last decade appear to be receding.

Top Decile S&P 500 Companies By Low PE to Growth



Source: BofA US Equity and Quant Research, as of 2/10/21

As we enter a period of strong economic recovery, we expect cyclicals and GARP stocks to outperform. The Fed will likely be forced to raise rates faster than they are currently projecting, and the P/E multiples on the most expensive stocks and work from home beneficiaries will compress. We expect GARP to resume its leadership position in the market and once again provide portfolios with "all-weather" growth and performance characteristics. Over the last 30 years, I have not seen a better time for active management and GARP.