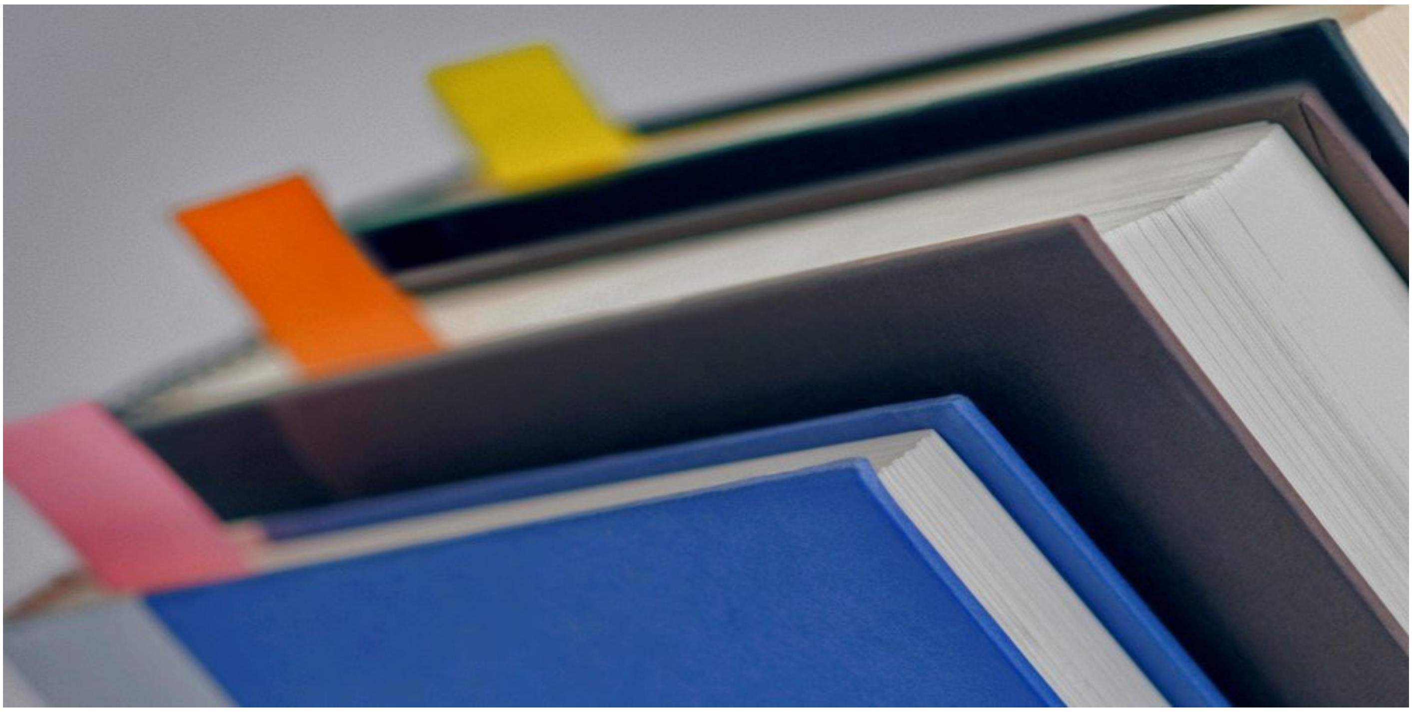

3 Lessons From 2020

January 21, 2021

While reviewing the prior year and forming an outlook for the market, it is impossible not to take greater stock of the world events and think more broadly about lessons learned during this time, which has been unlike any other we have experienced in our lifetimes.

As we consider these lessons, it is informative to draw comparisons to what we believe are critical factors for companies and their stocks, and our own experience as investors and businesspeople.

Lesson 1: Strong Culture Is Essential

First, there is no substitute for world-class culture. This means organizations that attract great talent and provide an environment where individuals can flourish. Great management teams lead and empower people to help achieve success for their clients.

During the pandemic we saw increased differentiation among those companies who are innovative, forward-looking, and agile, and that have adapted to overcome multiple challenges to stay relevant to their customers.

It is too simple to point to the alleged “COVID beneficiaries” who saw a boon to their businesses due to forced changes in consumption and business practices. It is more about those companies that have invested in leading data-driven, digital support to pivot or take advantage of the demand disruption. These companies form the core of each of our investment strategies.

What we are seeing from the best companies is their preparedness and ability to navigate through the crisis in terms of protecting client relationships, managing resources effectively, and executing around their strategy. As in all crises, we expect the best will not only survive but emerge stronger, with improved competitive positioning and more enduring growth prospects. This is where we are continuing to focus.

This relates to our own experience working on our clients' behalf in 2020. Our team demonstrated great resilience, commitment, and adaptability.

Once again we saw that outstanding people and a committed team culture can overcome a lot of obstacles. The collaborative, engaged nature of our investment process has prepared us remarkably well for this more decentralized, virtual form of work and connectedness.

The content of our research has never been richer. And the engagement and commitment of the team have never been stronger. Our long-term growth research projects this year were not just a triage for the current crisis, but an opportunity for deeper, reflective work on its longer-term growth implications. This has provided cohesion and consistency to our process.

Lesson 2: Growth Is a Critical Business Imperative

The second lesson is the importance of growth. Growth is a critical business imperative as it applies to people, products, and ideas. We are attracted to growth companies because we feel that they will add the most value to the future global economy and generate sustainable value creation in the form of cash flows that are underappreciated today.

These are three very specific and important words: create, meaning that companies are in control of their destiny; value, referring to positive economic outcomes; and sustainable, referencing durability over a long period of time.

This is of particular importance because in recent years the shares of companies classified as having higher long-term growth have substantially outperformed those of companies classified as value investments.

This stock market recovery has been unique in that it has been driven by the same types of companies that have led the market for several years: highly innovative "digital winners," those with high and persistent investment for future growth, and companies that have been able to scale at an unprecedented pace. This has fueled the performance of "growth versus value" and the ensuing debate around future equity-investing style performance.

While these market leaders (growth stocks) may have high current multiples (i.e., not equating to value classification), their earnings power has proved to be undervalued. The market is still trying to reconcile the digital transformation of business models and the resulting scalability at higher-than-expected profit levels. Or, put differently, the durability of that growth and profit profile is underappreciated. The style-performance differential therefore reflects a realization that the corporate performance gap is widening.

As a firm and as a team, we often reflect on the fact that we should run our own business and hold ourselves accountable to the same sustainable value-creation standards as our portfolio companies. Our firm is 85 years old and our team is 25 years old. Growth is an imperative to a successful long-term franchise, including our own.

That means people and people development: hiring bright minds with diverse perspectives and giving them an opportunity to grow and flourish. They demand growth.

It means challenging our investment philosophy and process with new ideas and evolving (growing) our investment skills and tools so that we are as relevant today as we were 10 and 25 years ago.

It also means innovating and creating new investment products that meet our clients' current and future needs. This, in turn, creates an energized, positive environment that allows us to maximize the contribution of all of our teammates to generate long-term returns for our clients.

Lesson 3: ESG Is Here to Stay

This leads to the next lesson, which is that the prominence of environmental, social, and governance (ESG) considerations and sustainable business practices is here to stay.

Society at large and (more recently) the investment community have woken up to the fact that long-term thinking is the foundation of business success and investment returns. Building durable, sustainable, enduring businesses and societies is the goal, and the stock market is increasingly recognizing these factors as being important organizational values.

We have long seen the obvious connection between long-term corporate value creation and ESG practices. The best companies that we referred to previously are increasingly focused on their business activity's impact on all stakeholders.

We have significantly elevated our incorporation of ESG in the last three years, and we now have a robust, proprietary approach that importantly is embedded in our existing research and corporate evaluation process. This is not political or social—it is common sense.

Moving Forward

Certainly, these lessons will inform how we do business—both how we operate our business and how we analyze companies—as we move forward from a challenging year.

But the future is bright.

We expect the economic recovery in 2021 to be extremely robust and surprise to the upside. Consumer spending is likely to grow across developed markets as pent-up demand and high aggregate savings rates work in tandem. At the same time, industrial production, which enables the consumption of these goods, remains some 7% to 10% below pre-COVID recession levels.

The aforementioned performance gap between growth and value stocks may even have a chance of moderating this year as the broadening of growth may support the performance of stocks in value-oriented industries that stand to benefit from increased economic activity.

We still believe the long-term investment potential of creators of long-term value (growth stocks) will prove to be superior to that of companies or industries in competitive decline.

Ken McAtamney, partner, is a portfolio manager on William Blair's Global Equity team.

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