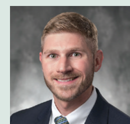
GENERATING ALPHA VIA GROWTH

Investing in growth can be risky, but finding the right companies may generate alpha



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The strategy has a fundamental tendency toward quality stocks, but you increased that position even more in early 2018. What was the rationale?

High-quality bias is the tangible output of our philosophy and process. If you take a look at the return on assets, return on invested capital and profitability margins of the companies within the portfolio, these metrics are all well above the Russell 1000 Growth Index benchmark and we think over time that will remain the case.

In early 2018, we believed we were approaching the end of the economic cycle and that there was the potential for greater volatility ahead. With that in mind, we decided to remove some of the cyclicality from the portfolio and tilt further toward profitability. We looked across the portfolio and isolated areas where there might be potential earnings risk in a more volatile environment. We decreased our positions in some financial names like Citigroup and Schwab. We also cut exposure to some of the more cyclical semiconductor stocks and removed several cyclical industrial positions. We took that capital and invested in businesses we thought could outperform throughout the cycle, such as Microsoft, Nike and VF Corp.

So how did the portfolio hold up to the stress test of fourth quarter 2018?

We outperformed the benchmark during that period. Overall, 2018 and 2019 were good examples of how we aim to run the portfolio. We will participate in a bull market – we even managed to add some alpha during the very strong market of 2019. But during periods of drawdown, when there is significant controversy or risk-off in the market, we expect the high-quality nature of the companies we own to outperform.

How do you identify these companies?

In terms of portfolio construction, there are three discrete steps. First, we look for the best companies. At this stage, we're not concerned with whether it's a good stock or not – we are just trying to identify a group of great companies.

To find good businesses, we begin by screening for clues of competitively advantaged business models – things that would signal structurally enduring businesses. These characteristics would be strong, or improving, gross margin and operating margins, return on assets or return on invested capital. At the same time, we'll do comprehensive, fundamental due diligence, making sure that the characteristics revealed by those metrics are related to something structural in the business model.

From there, we select the best stocks based on both near-term and long-term return potential, as well as minimizing downside risk. The final step will be portfolio construction that integrates risk management controls to ensure that stock selection is being accentuated as the key driver of tracking error.

Is the real alpha driver finding long-term competitively sustainable companies?

Investing in the growth universe is very challenging because these companies' high margins by definition invite competitors or disruption. As such, the failure rate of large, attractive growth companies is extremely high. But at the same time, investors love the idea of future profitability, particularly in a time of low interest rates, so they're often willing to overpay. In our universe, there's significant downside risk at the stock level. Our goal is to find a company that has something unique that allows it to fend off competitors and disruptors and deliver growth for a longer period. We don't always get it perfectly right but if we can shift that failure curve upwards and own companies that are able to persist in meeting, or beating expectations, longer than expected, then we are creating alpha for investors.

You don't own growth stocks such as Tesla, why?

Tesla falls into a bucket we call hyper unproven growth companies. These are stocks that have wonderful growth prospects and a potentially large addressable market, but they don't yet have the metrics or the business models to prove they are able to be competitively advantaged businesses. Another example would be Netflix, which is only just now forecasted to generate positive free cash flow. The key point is that we cannot say with any conviction where the earnings before interest, taxes, depreciation, and amortization (EBITDA) margin and free cash flow margin profile of these companies will be in the next three to five years.

Empirical data shows that investors ultimately have very high expectations of growth companies, and they can be sharply de-rated if they do not meet these expectations. Can a company like Netflix, which is facing a very competitive market, generate 30% EBITDA margins and 25% free cash flow margins? That's what investors want and we are skeptical about the company's ability to meet those expectations. So, we are treading lightly and looking for more confirmation. It's the same with Tesla. Clearly, it can make a great car, but we think there are significant hurdles to clear before the business model is proven.

What are some of the companies that typify the way you select stocks?

Estée Lauder fits into our core portfolio because it's a global leader in beauty, and we see sustained organic growth in the category, specifically in developing markets. Estée also has the desired characteristics, such as attractive return on invested capital, 75%+ gross margins and strong free cash flow.

Coca-Cola is another position we initiated in 2019. It can surprise people that, as a growth investor, we own Coke, but our reasoning is very clear. It's a dominant player in the global beverage market, which is growing at 3% to 4% per year. Coke is in a position to drive innovation, providing share gains, as well as generating price and mix benefits. In the most recent quarter, Coke reported organic revenue growth of 6% on an adjusted basis, a level we see as attractive and durable.

What we truly like about Coke is that it has re-franchised its bottlers, so the entire channel – from Coke down to the bottlers – is now focused on driving revenue growth as opposed to volume growth. The entire channel is favoring price and mix over volume, which we believe will be a driver of margins over time. We are seeing strong organic growth, improvements to the margin profile, and strong free cash flow generation. We think the company is set up well over the next two or three years.

Fund Performance – Average Annual Total Returns (%)

As Of 12/31/2019	Ticker	Inception	1-Year	3-Year	5-Year	10-Year	Gross/Net Expense Ratio
Class I	IYGIX	02/04/2007	36.86	21.94	14.50	14.48	0.81/0.69
Russell 1000 Growth Index	–	–	36.39	20.49	14.63	15.22	–
Morningstar Large Growth Category Average	–	–	31.90	18.09	12.10	13.40	–

Data quoted is past performance and current performance may be lower or higher. Past performance is no guarantee of future results. Investment return and principal value of an investment will fluctuate, and shares, when redeemed, may be worth more or less than their original cost. Please visit ivyinvestments.com for the Fund's most recent month-end performance. Total returns include share price changes and reinvestment of dividends and capital gains. Class I shares are sold without any front-end sales load or contingent deferred sales charges. The Russell 1000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It is not possible to invest directly in an index. The Morningstar Large Cap Growth Category Average measures the performance of large-cap stocks that are expected to grow at a faster pace than the rest of the market as measured by forward earnings, historical earnings, book value, cash flow and sales. Stocks in the top 70% of the capitalization of the U.S. equity market are defined as large-cap.

Past performance is not a guarantee of future results. This article is for informational purposes only. The opinions expressed are those of the Fund's manager and are not meant as investment advice or to predict or project the future performance of any investment product. The opinions are subject to change at any time based on market and other current conditions, and no forecasts can be guaranteed. This commentary is being provided as a general source of information and is not intended as a recommendation to purchase, sell, or hold any specific security or to engage in any investment strategy. Investment decisions should always be made based on an investor's specific objectives, financial needs, risk tolerance and time horizon. Top 10 holdings (%) as of 12/31/2019: Microsoft Corp. 9.1, Apple, Inc. 6.2, Alphabet, Inc. 5.0, Visa, Inc. 4.7, Amazon.com, Inc. 4.5, Facebook, Inc. 3.1, Coca-Cola Co. 3.0, Booking Holdings, Inc. 2.8, Cerner Corp. 2.8 and Motorola, Inc. 2.8.

Risk factors: The value of the Fund's shares will change, and you could lose money on your investment. Investing in companies involved primarily in a single asset class (large cap) may be more risky and volatile than an investment with greater diversification. The Fund typically holds a limited number of stocks (generally 40 to 60), and the Fund's portfolio manager also tends to invest a significant portion of the Fund's total assets in a limited number of stocks. As a result, the appreciation or depreciation of any one security held by the Fund may have a greater impact on the Fund's NAV than it would if the Fund invested in a larger number of securities or if the Fund's portfolio manager invested a greater portion of the Fund's total assets in a larger number of stocks. An investment in the Fund is not a bank deposit and is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Not all funds or fund classes may be offered at all broker/dealers. These and other risks are more fully described in the Fund's prospectus.

Through July 31, 2020, IICO, IDI and/or WISC have contractually agreed to reimburse sufficient management fees, 12b-1 fees and/or shareholder servicing fees to cap the total annual ordinary fund operating expenses (which would exclude interest, taxes, brokerage commissions, acquired fund fees and expenses and extraordinary expenses, if any) as follows: Class I shares at 0.69%. Prior to that date, the expense limitation may not be terminated without the consent of the Board.

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