Investment Insights Series | August 2012

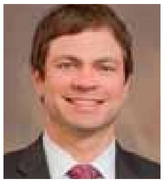
Growth for the Long Run

Finding Capital Appreciation Potential in a Low Return World

Summary Investors around the globe are grappling with a common challenge: Investing in the face of macroeconomic uncertainty and high market volatility with an eye towards meeting future spending needs. Basic investment principles have fallen by the wayside as investors have become fearful and headline-driven, losing sight of proper portfolio diversification and long-term goals. Fixed income and alternatives have been the primary beneficiaries, with equities—historically the best source of capital growth—dismissed or simply ignored. We believe that cautious investors in need of capital appreciation would be well-served to take a prudent approach to equity investing through an allocation to durable, long duration growth companies. We believe an independent-minded, fundamental research approach is best suited to identify these companies that have the potential to perform well in a variety of economic environments and therefore compound returns and deliver attractive capital appreciation in a slower-growth world.

Jonathan Coleman, CFA
Co-Chief Investment Officer

Jim Goff, CFA
Director of Research



Nick Thompson
Director of U.S.
Equity Strategies

Growth for the Long Run

"I skate to where the puck is going, not where it's been." – Wayne Gretzky

Many investors would love to be as successful as The Great One when it comes to their portfolios. Yet investors are often heavily influenced by the past, losing sight of where they need to be going. This seems to be especially true today: mistrust of equities is running high after a decade of poor returns and excessive volatility. Investors of all kinds are grappling with how to bridge the gap between their current assets and the increasing present value of their future spending needs and liabilities. However, according to industry flow data, most investors have been reducing their exposure to stocks and increasing allocations to fixed income and absolute return strategies—asset classes not typically known for high levels of capital appreciation.

Given our long-standing belief that successful investing is predicated on thinking independently to help uncover opportunities that others may overlook, we offer the following "alternative" approach for investors challenged by today's underfunding conundrum and asset allocation paradigm. Simply put, we believe that even cautious investors should refocus on their equity allocation and consider a prudent approach to gaining capital appreciation. One such way that we advocate is through a portfolio of durable, long duration growth equities—companies that have the potential to compound value for a long period of time—as a means to reach investors' return objectives and help close the funding gap between their assets and liabilities.

These are some of the most challenging—and also opportune—investment conditions we have seen in Janus' 40-years of equity investing. We hope that you find our insight and perspective both thought provoking and helpful.

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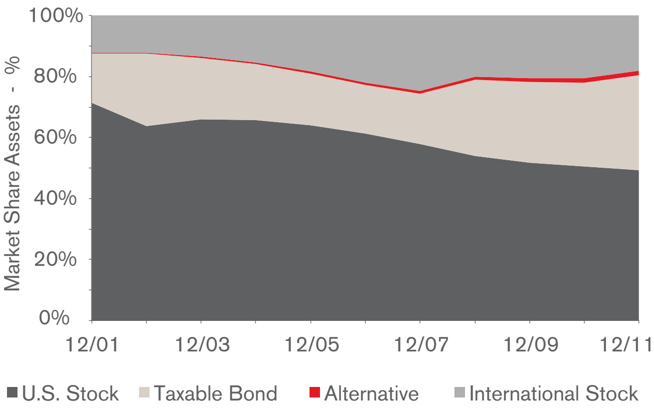
Bridging the Funding Gap

It's a simple conundrum: future funding needs are growing, while assets designed to meet those needs have not kept pace. For many investors, this is a significant problem that has only grown more severe as equity markets have performed poorly in the last decade, generating returns well below the historical average. History shows that asset classes tend to recover following long stretches of weak performance, generating returns closer to (or above) their historical average. Yet instead of increasing exposure to equities—traditionally the best source of capital growth—investors have reduced their equity allocations and boosted exposures to fixed income and alternatives (see Exhibit 1).

Exhibit 1

Equity exposure has declined as allocations to fixed income and alternatives have increased.

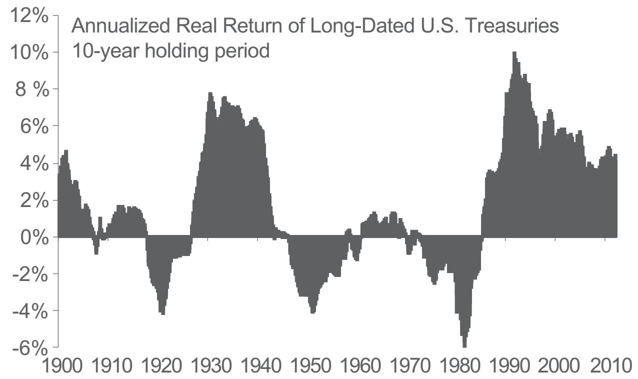


Source: Strategic Insight. Includes all openend mutual funds. As of 12/30/11.

Although these moves may reduce aggregate portfolio volatility, the returns will likely fall short of the growth needed to meet long-term obligations and future spending needs. Investors looking backward might not agree as fixed income has been on a bull run since the early 1980s. However, this experience is a historical outlier. As rates have declined, bond returns have been greater than historic norms while excess returns in equities have been the lowest since the 1930s (See Exhibits 2 and 3). With fixed income yields near record lows, however, it is unlikely that bonds will continue to exhibit such strong performance, increasing the importance of long term capital appreciation from an equity allocation. Investors who thus allocate assets based on the trends of the last decade, in our view, are unlikely to reach their long term goals.

Exhibit 2

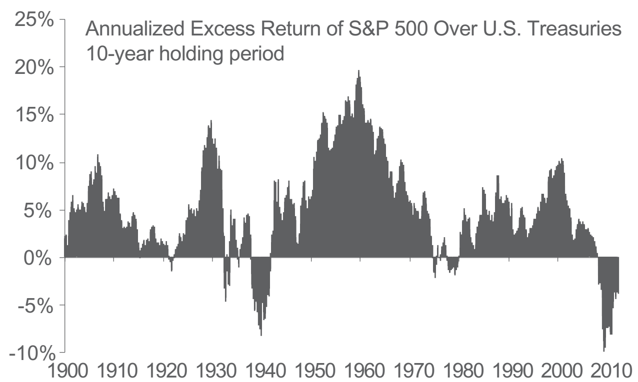
Bond returns have been unusally high…



Source: Robert Shiller, Datastream,Goldman Sachs Global ECS Research.

Exhibit 3

While excess returns in stocks have been historically low.



Source: Robert Shiller, Datastream,Goldman Sachs Global ECS Research.

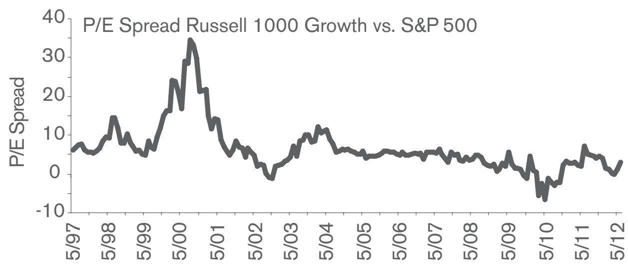
Growth Equities: The Elephant in the Room

Demand for "risk-free" assets has soared as investors have pulled money out of stocks seeking the "protection" of U.S. Treasuries or other bonds perceived to be safe havens. A significant decline in equity valuations has been the result. Several forces appear to have driven this trend: investor unwillingness to pay as much of a premium for future growth given lower expectations in the wake of the Great Recession and credit crunch; a high degree of global macro uncertainty; and, unknown austerity measures likely to be implemented in the future.

Whatever the cause, the result of this de-rating of equities is that starting valuations for growth stocks—an important driver of future returns—look attractive. Historically, growth stocks have had higher Price-to-Earnings Ratios (P/Es) than the broader market, reflecting higher earnings expectations and systematic risk associated with growth companies. However, P/Es for growth stocks have declined in recent years, along with spreads between growth stocks and the broader market (See Exhibit 4). These trends likely reflect lower expectations for growth. But they also provide a more attractive risk/reward profile, in our view. Investors can now buy growth for less of a premium, even as the fundamentals of many companies have improved: balance sheets are generally stronger, companies have higher cash balances and returns on equity have risen in aggregate from levels before the Great Recession (see Exhibit 5).

Exhibit 4

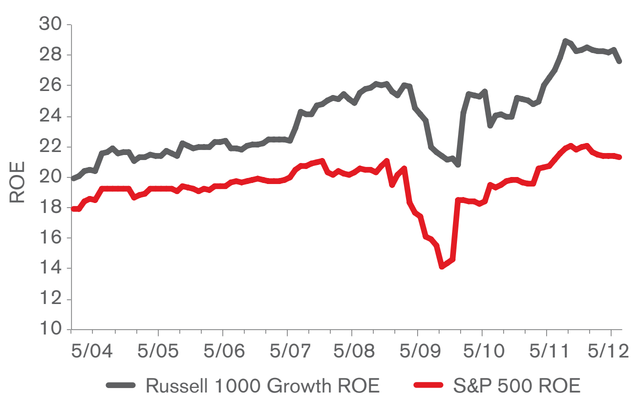
P/Es spreads have declined



Source: FactSet. As of 6/30/12.

Exhibit 5

Return on equity has continued to rise for growth companies.

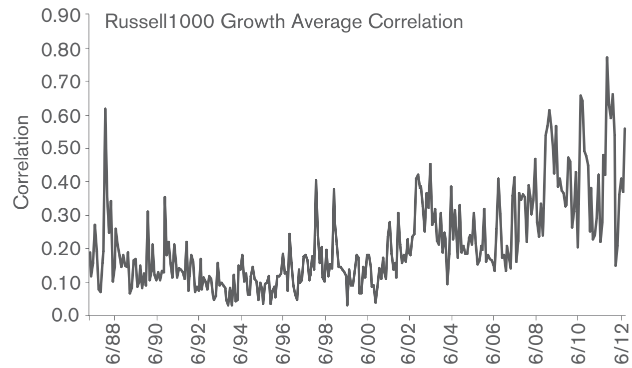


Source: FactSet. As of 6/30/12.
The Russell 1000 Growth Index is used as a proxy for growth companies.

Another important factor to consider is that correlations between equities have come down from their highs but stayed above average, as macro fears have continued to impact markets. This excessively high period of correlations is abnormal from a historical perspective, as Exhibit 6 suggests, and it is unlikely to persist. It has also resulted in attractive valuations for the best positioned companies as stocks have largely moved in unison. In short, investors may not be thinking about long term capital appreciation with equities, despite evidence that the risk/reward profile and fundamentals of many growth companies have improved.

Exhibit 6

Correlations for growth stocks remain higher than long-term averages.



Source: Citigroup. As of 6/30/12.
The Russell 1000 Growth Index is used as a proxy for growth companies.

Granted, the pressures weighing on multiples are significant. The global economy is slowing and corporate profit margins are near record highs—indicating less potential for expansion from here. Moreover, many companies have grown earnings through cost cutting and labor productivity gains, while revenue growth stagnated. These earnings drivers may be less powerful going forward, making it more difficult for companies to grow free cash flows.

For well-positioned companies in attractive industries, however, we think earnings and margin growth can continue. Given that an investment is worth the net present value of its future cash flows, equities that have the potential to grow those cash flows through the economic cycle should be a compelling investment compared to alternatives that have no potential to grow their cash flow (such as fixed income). The key, we believe, is to identify companies that have durable, long duration growth drivers and the ability to grow in a slower growth world.

Identifying Durable Growth: Why Qualitative Factors Matter

An opportunistic, research based approach is prudent given that durable growth companies don't always reside in only one area of the market. While quantitative factors such as high returns on invested capital (see sidebar) and rising free cash flow can be a good starting point for analysis, we believe qualitative attributes ultimately determine if a company's growth will be sustainable for the long term. Companies with competitive advantages and unique, differentiated business models, for example, can not only survive but thrive when confronted with tough macro conditions. We find the most attractive of these companies tend to have pricing power and growing end markets. And in many cases, they operate in an attractive industry—i.e. one with few competitors, low customer concentration and high barriers to entry. Other important elements include a corporate culture that promotes employee buy-in and innovation; an advantage over competitors that is well protected and leads to pricing power; and an attractive risk/reward profile—where the stock isn't trading at a significant premium to the value of its business. There is often less risk of fundamental missteps when companies have these attributes and a more attractive risk/reward profile in the stock. While not all inclusive, these elements most often form the cornerstones of durable growth.

The major indices may include a number of these stocks, but active managers can identify and overweight these companies in a portfolio, creating the potential for improved relative performance. Indeed, empirical evidence suggests that managers who differ significantly from the benchmark—for example, stock pickers with a high "active share"—are more likely to outperform than "index huggers" (see sidebar).

Durable Growth Equities: A More Cautious Solution for Long Term Returns

Investors who need to close the gap between their assets and future funding needs should consider increasing their equity allocation to durable growth stocks that can provide sustainable capital returns over a market cycle. We believe investing in companies with strong business models and long-term growth drivers can result in strong positive returns over time. Entry points for growth stocks look compelling in our view based on a number of valuation metrics, including relative price/earnings ratios and valuations compared to fixed income. Even if the global economy weakens, companies with strong business models and durable growth drivers are more likely to gain share, improve their competitive positioning and compound growth for shareholders.

We believe an in-depth, fundamental stock picking approach that combines qualitative and quantitative analysis can identify such stocks. The key is to analyze the sustainability, duration and magnitude of growth; use valuation tools to ensure optimal risk/reward; and invest with conviction in the face of market volatility and uncertainty. While the short term is always unpredictable, adding these companies to a portfolio creates a greater likelihood of achieving strong long-term returns that can meet investors' future funding needs. ■

Built to Last: Durable Growth Examples

Durable competitive advantages are critical for companies to overcome external forces that can erode margins and growth. High competitive intensity in an industry often results in limited pricing power. One goal of in-depth research, we believe, is to identify companies that can overcome such pressure points and maintain returns as their operating environment changes.

Furthermore, these types of companies should create a virtuous feedback loop where rising free cash flow can create capital for reinvestment or mergers and acquisitions (M&A)—further solidifying the business's competitive advantage. Consider the case of Precision Castparts, a leading manufacturer of aerospace parts and structures. Its competitive advantage is its ability to make a range of components with consistent high quality, in large capacities and for the lowest cost. Barriers to entry are high in its industry, including significant capital expenditures and technological capability. The company has used M&A to expand into adjacent areas such as products for power generation and oil-and-gas without losing its core focus on precision manufacturing. And its returns have risen sharply over the last decade while its balance sheet has improved—putting the company in a position to continue gaining share and strengthen its business.

Oftentimes, a company's competitive advantage is not so obvious. In these cases, it's advantageous to build a comprehensive mosaic through extensive independent thinking to identify the combination of factors that drive a company's enduring competitive advantage. Take for example, Polaris Industries, a manufacturer of motorized recreational products including snowmobiles, all terrain vehicles, and motorcycles. In its highly cyclical, consumer-driven end market, Polaris has improved its market position from #5 in 2005 to #1 in 2010, passing industry stalwarts such as Harley Davidson and Honda. Strong culture, a unique and differentiated playbook, strategic thinking and a good business model have helped Polaris to trounce its competition. For investors who understand and have conviction in the company, market noise and macroeconomic pressures have provided opportunities to buy the stock at attractive valuations.

Active Share: Why Active Stock Picking Matters

After many years of extreme volatility and poor returns, investors may be spooked by the markets and averse to active management. Yet academic evidence suggests that stock pickers who differ significantly from their benchmark index are more likely to outperform over long periods than so-called “index huggers”—highlighting the potential value of truly active management.

A standard measure of a portfolio’s difference from its benchmark index is called active share. For example, suppose a portfolio has a 2.60% position in Company A. If Company A has a 1.55% benchmark weight in the index, the portfolio’s active share for the Company A position is 1.05%. The sum of all the positively active positions in the portfolio yields a value between 0% and 100%, representing the percentage of the portfolio that differs from its benchmark. This value is the active share and can give investors some insight into both the riskiness of the portfolio as well as its propensity to outperform.

According to academic researchers Martijn Cremers and Antti Petajisto, portfolios with an active share of 80% or more had a tendency to outperform portfolios with an active share below 80% (for a 25 year period ending in 2003). The magnitude of outperformance varied by style, but averaged roughly 200 basis points annually—a statistically significant amount.[1] While high active share is no guarantee of outperformance, portfolios with the highest active share due to stock picking outperformed portfolios with high active share based on factor bets such as allocations based on sectors or style.

To learn more about how active share can provide insight into the potential riskiness of a portfolio and its propensity to outperform, read our paper titled “Assessing Portfolio Risk and Outperformance Potential: The Value of Active Share as a Complement to Tracking Error.”

Return on Invested Capital: A Key Element of Durable Growth

Many companies profess to be efficient allocators of capital—investing in new products or capacity, or engaging in mergers-and-acquisitions to generate growth. Yet pursuing growth is not always ideal for shareholders—especially if the investment required to generate growth yields low returns on capital. Only a fraction of companies make truly wise capital allocation decisions, in our view, and firms that focus on strategies geared toward improving the quality of growth are the ones that will likely add shareholder value over the long term.

One way to determine whether value is being created or destroyed is to analyze a company’s return on invested capital (ROIC). Analyzing ROIC helps to answer three key questions about a business: how much profit is the company able to generate with each dollar of capital? What is the cost of that capital? And how does this impact results? If companies aren’t careful, they can actually destroy value by investing in projects that earn a return below their cost of capital. Shareholders then pay the price for this value destruction. The industrial conglomerate Tyco International, for example, saw its ROIC decline from 2000 to the end of 2002, even while it achieved an average revenue growth rate in the mid-teens. Consequently, its stock price and price-to-earnings (PE) ratio suffered. Contrast that example with Reckitt Benckiser, a household products company that more than doubled its ROIC from 2000-2005—and was rewarded with both a higher share price and P/E multiple.

These are not isolated cases. Historical analysis by Credit Suisse Reasearch shows that companies in the top quintile of ROIC outperformed companies in the bottom quintile over a 20+ year period (January 1990 - April 2012). Granted, there are many ways for companies to boost ROIC, some of which may generate greater shareholder value than others. Nevertheless, studying ROIC and its related components can provide important insights into the quality of a company’s growth and potential for long term value creation.

To learn more about the benefits of analyzing ROIC and how it can help identify and substantiate conviction in companies that are more likely to create shareholder value over the long term, read our paper titled “The Quest for Quality: Identifying Sustainable Long-Term Growth Opportunities Using ROIC Analysis.”

[1]Cremers, Martijn, and Petajisto, Antti, “How Active is Your Fund Manager? A New Measure That Predicts Performance” (March 31, 2009). AFA 2007 Chicago Meetings Paper; EFA 2007 Ljubljana Meetings Paper; Yale ICF Working Paper No. 06-14. Available at SSRN: http://ssrn.com/abstract=891719.

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