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Sea Changes

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What to Tell Your Clients:

- A long run of strong performance by U.S. equities has led to investor complacency.
- A paradigm shift is underway. Potentially rising U.S. rates and slow global economic growth are causing complacency to capitulate.
- As markets become less speculative, companies with steadier, more proven growth profiles should return to favor.

A sea change is underway in equity markets. An era of complacency is washing away, as the anticipation of rising rates and global economic concerns usher in a market more grounded in reality. These shifting tides have particularly big implications for small- and mid-cap equities, where a risk-on environment has created areas of froth and speculation during the market run-up. The key going forward may be to seek companies with more sustainable growth profiles that don't need cheap debt or an economic tailwind to stay afloat.

An extended bull run has provided a backdrop for complacency

Fueled by historically low interest rates, U.S. equities have gone through one of the longest, sustained periods of positive performance in market history. The six-year run without a 20% correction is the third-longest bull market U.S. equities have ever experienced. To put the lack of turbulence in better perspective, consider that until fears about Chinese economic growth led markets down in August, we had gone more than 1,400 days without even a 10% market correction, an unusual streak of market buoyancy.

During much of the climb (particularly 2013 and early 2014), multiple expansion, rather than earnings growth, was the primary driver of returns. Rarely have up markets been driven so predominantly by expanding multiples.

With markets heading straight up and multiple expansion driving stocks in the same direction, investors didn't have to be discerning to win. They just had to participate. Such environments set a backdrop for complacency, and valuations in both the public and private markets suggested an irrational confidence in the growth potential of some companies.

One of the more poignant examples of market froth was the IPO launch of a popular hamburger joint in early 2015 that valued the company at $35 million per restaurant. To put that number in perspective, Chipotle, one of the few other quick-service restaurant chains that also directly owns its stores (as opposed to selling franchise rights), is valued at only $12 million per restaurant. The high IPO valuation is one of many examples of excess that took place in the market run-up.

High valuations for early-stage biotech companies provide another sign of potential excess. The valuations of select mid-cap biotech companies with no commercial products imply these companies will ultimately deliver several billion dollars in revenue in the coming years. This would require multiple blockbuster drug launches. That's a lot to expect for a young company with no existing treatments.

A new tide is rolling in

We believe we are at a crucial tipping point in which markets are becoming less complacent and less speculative. Questions about weak global economic growth, particularly in China, abound. At the same time, the Federal Reserve is getting closer to stepping away from its most accommodative monetary policy era in history, by raising rates for the first time in nearly a decade.

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About the Manager:

Brian Demain, CFA, joined Janus in 1999 and has been managing the Janus Enterprise Fund since 2007.

Janus Enterprise Fund: Portfolio Snapshot

- Emphasizes "smart growth" companies exhibiting sustainable growth and high return on invested capital potential.
- Seeks businesses that prudently invest capital to emphasize longer-term value creation and fund high-quality growth.

These two forces are causing market complacency to capitulate. This was evident in late August, when stocks sold off broadly due to questions about China's economy. Interestingly, the mid-cap stocks that sold off hardest during the month were those with the highest multiples (Price/Earnings ratios). The sharper sell-off of this group is evidence the market is now taking a harder look at the growth potential implied in the valuations of many small- and mid-cap companies.

None of this suggests equities are headed for a longer-term free fall. But a paradigm shift is taking place within equity markets that is creating a market backdrop more grounded in reality. Earnings and cash flow growth, rather than multiple expansion, should drive returns again. Market psychology is changing from what might go right to what may go wrong for individual companies. These changes will likely have a bigger effect lower down the market cap spectrum, as mid- and small-cap markets experienced more speculation in a risk-on environment.

What it means for mid-cap investors: Find durable, non-speculative growth

As market sentiment shifts, small- and mid-cap investors should be careful where they play. When the market embraces risk, as it had for much of the past few years, it is not uncommon to see valuations driven up excessively for younger companies where the addressable market or competitive landscape is less defined. As market psychology changes, speculative paths to growth are called into question and multiples contract for a number of these highly-valued companies. This is particularly true in an environment where multiples have already expanded considerably, and companies need to demonstrate true earnings growth to see further stock price appreciation.

Companies with steadier, more proven growth profiles should return to favor when market sentiment changes tides. We believe slow global growth and rising interest rates are creating such a paradigm shift today. Companies that have demonstrated steady earnings growth will be more appreciated in an environment where broad economic growth looks harder to come by. A rising interest rate environment should also favor companies with more established growth profiles because they can rely on free cash flow, rather than access to cheap debt markets, to fund future growth initiatives.

We believe a focus on companies with more proven and sustainable growth is a better long-term approach to investing in mid-caps, but that focus is particularly important when a wave of cautious sentiment rolls in.

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As of 6/30/2015, Chipotle was 0% of Janus Enterprise Fund. There is no assurance that any Janus fund currently holds this security.

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