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Sector Views: Locating Profitable Growth

Growthier segments of the market came under pressure as investors began prioritizing shorter duration, current profitability, and dividend income. About 75% of the Russell 1000, the 1000 largest U.S. companies by market capitalization, have negative year to date returns[1] and about two-thirds are trading below their 200-day moving average.[2] While some valuation declines are justified, others could be solid entry points into oversold opportunities. This month we searched for such opportunities by looking at growth companies that exhibit current positive and forecasted higher profitability.

Style Breakdown

First, let's define the growth spectrum that companies can fall into when investing in this style of equities.

- Aggressive Growth - These companies are generally not currently profitable. They have a high cash burn rate and reinvest heavily in their business. They are typically newer companies, and their valuations are based on positive future cash flow expectations discounted back to today.
- High Growth - These companies are close to or are newly profitable. They continue burning through cash and reinvest heavily into their business. The major difference between these companies and Aggressive Growth is that they have a product on the market generating a reliable revenue stream.
- Profitable Growth - These are companies that have shown consistent positive earnings. They have a product that has become a staple of everyday life and have plans to continue innovating into the future. These companies balance the line between Growth and Core but skew towards growth.

Finding Profitable Growth

Vetting Valuations

We reviewed the investment universe across the Russell 1000 Index. The Russell 1000 makes up about 93% of the total U.S. market cap. This index can be broken down between the Russell 1000 Growth and Russell 1000 Value. We compared the weights of the Russell 1000 Growth Index to the Russell 1000 Value Index. If the constituent had a higher allocation in the growth index, then it was characterized as growth, if it was less, then it was value. Overall, there were 318 companies characterized as growth, constituting 49.9% of the Russell 1000 Index.

Then, constituents were grouped by sector with a focus on profitability. Profitability was split into two camps – profitable and not profitable. We took this further by looking at the estimated forward net income for each company.[3] If net income was higher than the latest net income, the company was categorized as improving, if it was below the latest net income then company was classified as deteriorating. As reflected in the chart below, this established the spectrum from not profitable and deteriorating to profitable and improving.

GROWTH PROFITABILITY ANALYSIS

	PROFITABLE				NOT PROFITABLE				TOTAL	
	Improving		Deteriorating		Improving		Deteriorating			
SECTOR	Count	Weight	Count	Weight	Count	Weight	Count	Weight	Count	Weight
Communication Services	8	9%	3	2%	2	0%	1	0%	14	11%
Consumer Discretionary	39	16%	8	1%	8	0%	2	0%	57	17%
Consumer Staples	11	5%	1	0%	2	0%			14	5%
Energy	1	0%			1	0%			2	0%
Financials	14	2%	3	1%					17	3%
Health Care	33	8%	6	1%	8	0%	8	0%	55	9%
Industrials	32	5%	4	1%	5	0%			41	6%
Information Technology	60	42%	4	0%	38	2%			102	44%
Materials	6	1%	1	0%					7	1%
Real Estate	4	1%	3	1%	2	0%			9	2%
Total	**208**	**88%**	**33**	**8%**	**66**	**4%**	**11**	**0%**	**318**	**100%**

By market cap, the majority of growth focused constituents are profitable. Out of 318 growth focused companies, 208 companies, representing 88% of the weight of growth focused companies, were both profitable and improving, while a further 8% were profitable and deteriorating. The sectors that showed the greatest number of profitable and improving companies were Information Technology, Consumer Discretionary, Communication Services and Health Care, in that order.

One layer deeper, from an industry perspective, the industries that contributed the most to the positive and improving segment were:

- **Information Technology**: 22 out of 50 constituents from the Software industry contributed 15%.
- **Information Technology**: 2 out of 3 constituents from the Technology Hardware industry contributed 12%.
- **Communication Services**: 4 out of 7 constituents from the Interactive Media & Services industry contributed 8%.
- **Consumer Discretionary**: 2 out of 4 constituents from the Internet & Direct Marketing industry contributed 6.5%.

Because some companies are more exposed to supply chain issues or are more sensitive to inflation, we also analyzed most recent profit margins and compared them to the three-year average. Either companies were operating with negative or positive margins, and either those margins were deteriorating or improving. This created an additional four camps, negative margins and deteriorating, negative margins and improving, positive margins and deteriorating and positive margins and improving. The same sectors, ranked in the same order, had the greatest weights of companies that have both positive and improving margins. From an industry standpoint, Software, Technology Hardware, and Interactive Media all remained on top with the inclusion of Semiconductors & Semi Equipment.

Finally, we ranked performance from best to worst for the Russell 1000 into quartiles. Out of the 147 growth companies that are both profitable and improving, as well as have positive expanding margins, only 19 of them are in the first quartile for performance. 23 are in the second quartile, 56 are in the third quartile, and 49 are in the fourth quartile. If equity valuations are based off future earnings, then current valuations, combined with forward expectations don't seem aligned. This may create entry points into what could be oversold opportunities.

Opportunities Remain in More Selective Market

In conclusion, even though the current market environment seems to favor more value focused, dividend paying companies, there are still opportunities available for investors to identify profitable growth companies. Selectivity is key, because while certain sectors may show profitability, if one takes a deeper dive on an industry level, certain industries in that sector are likely driving profitability while others are detracting from it.

Analyzing margin expansion may help identify industries that are more affected by supply chain issues and inflation pressures. This helps establish broader views on different sectors and segments of the market. Please see below for our current sector views.

CURRENT VIEWS ON U.S. SECTORS

	Positive Factors	Negative Factors	Overall View
Communication Services	Reasonably positive trends in subscription services, including streaming, benefit Communication Services. The sector is a potential future beneficiary of the development of augmented reality and metaverse.	Higher interest rates adversely impact the discount rate applied to future earnings and cash flows.	**Underweight**
Consumer Discretionary	Consumers adapted to the pandemic by increasing their use of online ordering and delivery and in-store pickup.	Consumer Discretionary is a labor-intensive sector. Wage pressure combined with higher input costs in materials and shipping is a risk to margins if companies are not able to pass inflation pressures to the end consumer.	**Underweight**

		This sector is adversely impacted by supply chain disruptions, especially the semiconductor shortage in the automotive industry. Delays in shipping by sea and heightened costs in air freight are headwinds.	
Consumer Staples	High inflation and slower real economic growth may force consumers to prioritize staples over discretionary purchases.	Inflation will negatively impact margins for companies that cannot pass through rising material costs to the end consumer. In our pricing power analysis, Consumer Staples generally scored poorly. Higher transport costs by air and sea may negatively impact company margins.[4]	**Market Weight**
Energy	Escalated tensions with Russia, a large natural gas exporter to Europe, could lead to elevated energy prices globally for an extended period.	Renewed COVID-19 lockdowns in China and reduced economic growth expectations may reduce oil demand. The Energy sector is sensitive to the economic cycle. Should elevated energy and food prices detract from real economic growth, reduced demand pressures may shorten the commodity cycle.	**Overweight**
Financials	The Financial sector benefits from higher interest rates with the Fed starting their interest rate rising cycle. Strong balance sheets, attractive valuations, and the continued cyclical rebound	Russia's invasion of Ukraine increased inflation expectations while reducing expectations for real economic growth. Flatter yield curve and elevated inflation weighs on sector. High cash levels and low loan demand are hampering	**Market Weight**

	underpin the case for bank performance.[5]	revenues, although loan growth turned positive recently.[6]	
Health Care	Demographics favor the Health Care sector due to the aging global population and the growing middle class in emerging markets. Sector is showing strong fundamentals, quality, and record discounts vs. the S&P 500 on a forward P/E basis.[7]	Drug pricing pressure remains a risk, though the legislative process is slow, and no meaningful legislation is currently expected to be passed.	**Overweight**
Industrials	The Industrials sector is a beneficiary of rising GDP, interest rates, inflation, and possible infrastructure spending. Re-shoring and a shift towards automation infrastructure spending will be a long-term benefit for Robotics & AI.	Elevated leverage, increasingly expensive valuations, and rising earnings volatility may detract from performance.[8] Supply chain issues could be a major headwind.	**Market Weight**
Information Technology	Software names should benefit from higher CAPEX as firms look to boost productivity amid rising wage inflation.[9] The increased adoption of key disruptive technologies like cloud computing, cybersecurity, and cleantech are likely to continue after the pandemic.	Increased regulatory scrutiny is a risk, and there is bipartisan support for increased regulation. Rising interest rates negatively impact long-duration growth sectors like Technology.	**Market Weight**
Materials	Increased focus on electric vehicle	Significant supply chain bottlenecks and slowdown in	**Market Weight**

	adoption, alternative energy sources, and energy storage should be beneficial to lithium and battery technology. The Materials sector is a beneficiary of higher raw materials prices.	China could dampen sector's growth. Dollar strength may weigh on this sector.[10]	
Real Estate	The Real Estate sector has the potential to be a source of inflation-protected yield. The focus on real assets and locking in mortgages before yields rise provided a short-term increase in property pricing with inflation pressures building on rents. Strong demand for residential REITs is translating into higher single family and multi-family rents.	Uncertainty about a full return to the office and flex working situations may reduce demand for office space. A fast rise in interest rates, which increases the cost of financing, is a risk if costs cannot be passed along to tenants.	**Market Weight**
Utilities	Benefits from resilient fundamentals and is a defensive hedge.[11] The preferred sector in recessionary environments due to the inelasticity of goods & services.	The potential for increased climate-related regulations over time may detract from the sector's appeal. Companies may not be able to pass through higher inflation-related costs due to government regulations.	**Market Weight**

Footnotes

[1] Bloomberg data as of 3/15/2022
[2] FactSet, ETF Action data as of 3/15/2022
[3] Based on Bloomberg Estimation (BEst Net Income) as of 3/15/2022
[4] FactSet, Earnings Insight, 10/22/2021
[5] BofA, The RIC Report: Get paid to wait, 1/11/2022
[6] Schwab, Sector Views: Financials, 1/25/2022

[7] BofA, The RIC Report: Peace Through Strength, 3/8/2022
[8] BofA, The RIC Report: America is Still Exceptional, 9/14/2021
[9] BofA, The RIC Report: Get paid to wait, 1/11/2022
[10] BofA, The RIC Report: Peace Through Strength, 3/8/2022
[11] BofA, The RIC Report: Bullish Stock Splits, Bearish Rate Hits, 02/08/2022

Definitions

Russell 1000 Index: The large-cap market index consists of the largest 1,000 markets in the Russell 3000 Index.

Russell 1000 Growth Total Return Index: The index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

Russell 1000 Value Total Return Index: The index measures the performance of those Russell 1000 companies with lowest price-to-book ratios and lowest forecasted growth values.