LOOMIS | SAYLES

MANAGER INSIGHT

Pursuing Consistent SMID Growth Returns

AUTHORS

MARK BURNS, CFA
Portfolio Manager

JOHN SLAVIK, CFA
Portfolio Manager

Investors in small- to medium-sized (SMID) growth companies know that emerging businesses can offer considerable opportunity but also pose some complex risks.

Companies in this segment can be volatile for a number of reasons given their niche markets, larger competitors and limited liquidity—all of which may have an outsized impact on a company's stock price.

While potential returns are enticing, how can an investor attempt to effectively balance risk and reward in this space? We believe a consistent return stream with lower relative volatility is a key to harvesting the potential benefits and managing the risks of SMID growth investing. Our goal is to compound steady returns into strong long-term risk-adjusted results. We seek to achieve this goal through a disciplined, risk-aware investment process.

Key Takeaways

- We believe strong performance is created through the long-term compounding of consistent returns.
- A disciplined, risk-aware investment process is more likely to generate consistent returns.
- Our beliefs inform every aspect of our investment process, including our emphasis on quality, undiscovered names and fundamental research.

Did You Know?

SMID GROWTH AND SMALL CAP GROWTH RETURNS ARE HIGHLY CORRELATED

Investing in SMID growth companies can provide exposure to the small cap growth universe, where access can be limited because of manager capacity. The Russell 2500™ Growth Index includes the 1,117 names of the Russell 2000® Growth Index, as well as an additional 175 mid cap names.[i] As a result, the correlation between the total return of the two indices is almost perfect at 0.99.[ii] Despite highly correlated returns, the Russell 2500 Growth Index is slightly less volatile; its standard deviation is 20.05% versus 21.17% for its smaller counterpart.[iii]

Our Philosophy and Approach to SMID Growth Investing

Our investment philosophy has been carefully designed to pursue strong risk-adjusted returns over full market cycles with a low-volatility approach to high-growth investing. The main tenets of our philosophy are:

- Companies with high-quality business models and secular growth opportunities tend to generate more consistent returns.
- High-quality companies that are under-recognized by the market tend to generate outsized returns consistently over time and present opportunities for bottom-up fundamental research to be rewarded.
- Inherent volatility of small and mid cap stocks requires a comprehensive, active approach to risk management to help preserve consistent excess returns generated from stock selection.

In the following sections, we explore how these beliefs inform the process by which we seek to identify high-quality, high-growth businesses with positive fundamentals that market participants have not fully recognized.

Why Quality Matters

We believe high-quality companies offer investors opportunities to compound consistent returns over time. We define a quality business as a small or mid cap company with strong potential to grow into a successful large cap company. To substantiate this belief, we constructed an analysis with the objective of creating a hypothetical investing environment to determine if the combination of stronger return on assets (ROA and a proxy for quality) and superior sales growth (a proxy for growth) could result in a better investment opportunity set. Specifically, each year we divided the constituents of the Russell 2500 Growth Index into thirds based on that year's ROA. Within each ROA bucket, we further grouped the securities into thirds based on that year's sales growth. We calculated various statistics annually for the nine buckets and then averaged the results over the 10-year study period. We observed higher ROA and sales growth companies had stronger returns and information ratios[iv] than their lower ROA and sales growth counterparts, as shown in the table on the following page.

This analysis supports our philosophy of seeking to identify high-quality businesses with above-average growth. So, how do we approach identifying the quality companies of tomorrow? In reality, quality has no perfect predictors. We view quality holistically because we believe quality is about a company's ability to grow into a larger entity in a way that creates value for shareholders, and no one metric reveals this business attribute. We have found quality companies often have differentiated, secular growth stories and business models that can generate cash. Our integrated process profiles businesses according to hard metrics and softer qualitative characteristics. The qualitative and quantitative aspects of our work converge in the development of our thorough company-specific quality profiles. To illustrate, we review our approach to two important analytical characteristics—revenue and earnings.

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TEN-YEAR ANALYSIS OF THE RUSSELL 2500 GROWTH INDEX FOR QUALITY & GROWTH CHARACTERISTICS

	HIGHEST THIRD ROA	MIDDLE THIRD ROA	LOWEST THIRD ROA	
Return	18.40%	6.80%	0.13%	HIGHEST THIRD SALES GROWTH
Information Ratio	1.3	0.8	0.01	
Turnover	19%	25%	21%	
Count	115	127	134	
Return	8.15%	0.38%	-10.00%	MIDDLE THIRD SALES GROWTH
Information Ratio	1.1	0.6	-1.0	
Turnover	22%	24%	22%	
Count	160	128	74	
Return	-3.83%	-8.22%	-10.90%	LOWEST THIRD SALES GROWTH
Information Ratio	-0.4	-0.9	-2.2	
Turnover	21%	15%	20%	
Count	149	132	120	

Source: S&P Capital IQ, Loomis Sayles analysis from 31 December 2014 to 31 December 2024. The underlying universe was the Russell 2500 Growth Index. Returns are annualized and include reinvestment of capital gains and dividends but do not reflect any fees or expenses. The analysis assumed a one-year holding and rebalancing period. Please see the Endnotes for a more detailed description of the methodology. This is for illustrative purposes and does not represent any Loomis Sayles investment product.

Past performance is no guarantee of future results.

For obvious reasons, revenue is an important aspect of a company's growth profile. We seek businesses with visible revenue growth and sustainable revenue streams, such as subscription services or backlog-driven business models. Predictable revenues help drive the magnitude and sustainability of growth by enhancing a company's ability to generate cash to reinvest in its business. While revenue numbers tell a quantitative story, the qualitative aspects driving them illuminate a company's long-term potential.

When assessing a company's earnings, we do not use a static earnings hurdle. Rather, we look for a company's ability to generate relatively steady earnings growth. Earnings stability can provide insight into other aspects of business quality. Consistent earnings may indicate increasing cash flow, which management must efficiently allocate to grow the firm. Relatively durable earnings growth often points to business model effectiveness and favorable competitive positioning. Both are key drivers of a company's long-term prospects. Assessing a company's earnings profile, coupled with these more qualitative aspects, furthers our understanding of a company's long-term prospects.

Our Investment Process

1. IDEA GENERATION

We use a proprietary growth screen and traditional fundamental analysis to source investment ideas. Roughly half of our ideas are sourced through the growth screen, which is informed by our investment philosophy. We also leverage our experience in fundamental research and network of industry and company contacts.

2. FUNDAMENTAL ANALYSIS

Regardless of the source, we research each investment idea using rigorous fundamental analysis. Given our focus on quality, we seek companies with visible and predictable growth drivers, strong competitive advantages, business model strength and management teams with vision and experience.

3. DISCOUNTED CASH FLOW (DCF) VALUATION ANALYSIS

To better understand and compare the reward-to-risk in high-growth businesses across sectors and industries, our primary valuation tool is DCF modeling. Critical model inputs are developed during our in-depth fundamental analysis.

4. BUY DISCIPLINE

We seek to initiate positions at a valuation offering a minimum 25% upside potential with a return-to-risk profile of two to one, upside to downside. We target at least a one-year holding period, although we prefer a multi-year holding period.

5. PORTFOLIO CONSTRUCTION

The portfolio is a diversified, style-pure SMID growth strategy with approximately 65 to 85 names. Position sizes are typically 0.75% to 3.0%, based on our level of conviction.

6. SELL DISCIPLINE

We actively monitor all holdings in the portfolio. A position can be sold or trimmed for several reasons: a stock attains our price target, the position grows to a portfolio weight that is beyond our fundamental level of conviction, the investment thesis deteriorates or we identify a better risk-to-reward opportunity. We follow a stop-loss discipline based on both absolute and relative price action, under normal market conditions.

7. INTEGRATED RISK MANAGEMENT

We believe a high-conviction active management process requires disciplined risk awareness. Our risk management is integrated into our investment process from the stock level to the portfolio level and from the buy discipline to the sell discipline.

Our Focus on Unrecognized Companies

We not only seek to invest in quality businesses but also those that have yet to be recognized by many investors. Market inefficiencies create an information gap between a company's stock price and our longer-term valuation expectations, a differential that is often more pronounced the less visible a company is in the market. SMID growth companies outnumber large cap growth companies by almost 3.3 to 1,[v] but large cap growth managers outnumber SMID growth managers by 2.3 to 1,[vi] resulting in far fewer investment professionals to cover a much larger investable universe. Our ability to efficiently identify quality companies where valuation disconnects exist is essential to achieving our long-term performance objectives. To discover these underexploited investment opportunities, we utilize a proprietary tool with the objective of identifying emerging winners early in their growth cycles. We concentrate our analysis on top-tier growth companies with favorable price and volume trends.

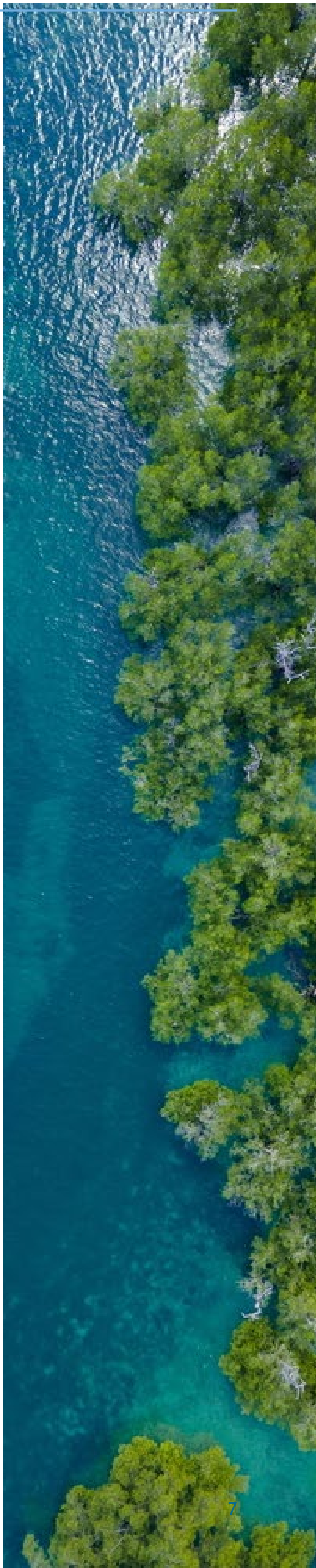
Once we identify portfolio candidates through this targeted screening process, we focus our fundamental research on valuation to determine if disconnects exist. Finding opportunities that others may overlook is integral to our process. Similar to developing a company-specific quality profile, our proprietary research results in a company-specific valuation model using discounted cash flow (DCF) analysis. DCF modeling's emphasis on future cash flows supports our belief that efficient capital use in high-growth businesses can lead to superior cash flow growth and create shareholder value over time. Companies may have different growth drivers, but a business' future success will often be seen in its cash-generating ability. We also favor DCF analysis because it tends to reward businesses and managements that allocate capital effectively; this analytical tendency supports our quality bias in the portfolio. Finally, cash flow is fairly universal, allowing for effective comparison across companies and industries. We believe using DCF models to value high-growth businesses differentiates our approach from many in the SMID growth space.

Our philosophy and focus on fundamental bottom-up research among underexploited companies results in a portfolio with returns that are typically driven by stock selection. Since the strategy's inception, a majority of our returns have come from stock selection rather than sector allocation, market timing or other factors. We believe this is important to sustaining performance over the long run.

Integrated, Holistic Risk Management

A high-conviction active management process requires disciplined risk awareness, since the majority of risk we assume is stock-specific, not factor risk. As a result, disciplined risk management—from the stock level to the portfolio level and from the buy decision to the sell decision—is integral to our investment approach.

- **BUY DISCIPLINE:** We match position sizes to our fundamental level of conviction and our estimate of business model risk. While the portfolio is built from the bottom up on a company-by-company basis, diversification is also built into our buy discipline through limited sector weights and position sizes. Combining relatively tight constraints with an active bottom-up stock selection process supports our objective of generating alpha through stock picking, not sector bets or other factors.
- **ONGOING MONITORING:** We actively adjust positions as needed to manage risk in the portfolio. We also manage risk on the security and portfolio level using several customized processes. To monitor the most appropriate risk metrics for our strategy, we utilize a proprietary risk management tool developed by our Quantitative Research and Risk Analysis (QRRA) group and tailored to our strategy objectives. Additionally, daily reports provide real-time risk information, including portfolio factor exposure, beta and individual security contribution-to-risk factors.
- **SELL DISCIPLINE:** We actively monitor all portfolio holdings, and sell decisions are typically a function of price target attainment or deterioration in the fundamentals of our investment thesis. However, we also have a clearly defined stop-loss discipline to highlight where our view is significantly at odds with the market. Material price deterioration over the trailing month can lead to further review and, most likely, a sale. This tool helps remove emotion from the decision-making process and supports capital preservation.



Summary

SMID growth stocks can introduce considerable volatility and, like the equity market in general, can have periods of negative return. However, many of these stocks also present significant long-term investment opportunities. In our view, success in this asset class requires a disciplined, risk-aware investment process. We believe strong performance is created through the long-term compounding of consistent returns from high-quality, underappreciated companies. Each part of our investment process reflects this belief—from initial fundamental research and active stock selection to overall integrated risk management. We are long-term investors and follow these tenets in the face of short-term market volatility. Together, these elements support our objective of generating consistent excess returns with volatility lower than the Russell 2500 Growth Index over a full market cycle.

This material was originally published in July 2014. We have updated the content as necessary and otherwise believe the information is current and relevant.

AUTHORS

MARK BURNS, CFA
Portfolio Manager

JOHN SLAVIK, CFA
Portfolio Manager

About Risk

Equity securities are volatile and can decline significantly in response to broad market and economic conditions. Investments in small and mid-size companies can be more volatile than those of larger companies. Foreign and emerging market securities may be subject to greater political, economic, environmental, credit, currency and information risks. Foreign securities may be subject to higher volatility than US securities due to varying degrees of regulation and limited liquidity. These risks are magnified in emerging markets.

Endnotes

[i] *FactSet as of 31 December 2024.*

[ii] *eVestment for 10 years ending 31 December 2024.*

[iii] *eVestment for 10 years ending 31 December 2024.*

[iv] *An information ratio is a measure of risk-adjusted return.*

[v] *FactSet as of 31 December 2024; the Russell 2500 Growth Index was comprised of 1,292 unique index constituents and the Russell 1000 Growth Index was comprised of 396 unique index constituents.*

[vi] *eVestment Alliance data as of 31 March 2025; 187 firms were classified as large cap growth managers, and 82 firms were classified as SMID growth managers.*

Analysis Methodology for Quality & Growth Characteristics of the Russell 2500 Growth Index

Time Period: *31 December 201 to 31 December 2024*

Universe: *Russell 2500 Growth Index*

Data Sources: *S&P Capital IQ for security prices and returns; S&P Capital IQ/Compustat for financial statement data to calculate return on assets (ROA) and sales growth; Russell Investments for index constituents. Performance data sourced and calculated by S&P Capital IQ's Clarifi backtesting application.*

Factor Construction Methodology: *ROA is the ratio of the trailing four quarters after-tax net operating profit to average total assets over the same period. Sales growth is defined as year-over-year percentage change in sales. Our factor construction methodology allows for the normal reporting procedure, which includes some delay after quarter-end—e.g., financial statements for the 31 March 2013 period are not used in the analysis until results are actually reported. To reduce the effect of outliers and data errors, factor values are capped at the 1st and 99th percentiles—i.e., the top (and bottom) 1% of each year's factor values are set to the largest (and smallest) values of the remaining 98%.*

Both ROA and sales growth are sector-neutralized, using the Global Industry Classification Standard (GICS®), as described below for each date:

- *Calculate the mean across all factor values in the same sector for the date.*
- *Calculate the standard deviation across all factor values in the same sector for the date.*
- *For each issue on that date, apply the following:*
  $ZScore_{issue} = (FactorValue_{issue} - Mean_{sector}) / Standard\ Deviation_{sector}$

Backtest Methodology: *Stocks are first classified into three equal buckets using the ROA factor (see construction above). Stocks are further classified into three buckets within the ROA buckets using the sales growth factor (see construction above). All stocks within the resulting nine buckets are equal weighted for the purpose of calculating returns and other statistics. All buckets are rebalanced yearly, and yearly buy-and-hold returns are used in all calculations. Returns are annualized and include reinvestment of capital gains and dividends but do not reflect any fees or expenses. Historical Russell 2500 Growth Index constituents are retrieved at the beginning of each year and thus include non-surviving companies that no longer exist today.*

Disclosure

Russell 1000® Growth Index *measures the performance of the large cap growth segment of the US equity universe. It includes those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values.*

Russell 2000® Growth Index *measures the performance of the small cap growth segment of the US equity universe. It includes those Russell 2000 Index companies with higher price-to-value ratios and higher forecasted growth values.*

Russell 2500™ Growth Index *measures the performance of the small to mid cap growth segment of the US equity universe. It includes those Russell 2500 companies with higher growth earning potential as defined by Russell's leading style methodology. The Russell 2500 Growth Index is constructed to provide a comprehensive and unbiased barometer of the small to mid cap growth market. The Index is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small to mid cap opportunity set and that the represented companies continue to reflect growth characteristics. Indexes are unmanaged and do not incur fees. It is not possible to invest directly in an index.*

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Diversification does not ensure a profit or guarantee against a loss.

Indices are unmanaged and do not incur fees. It is not possible to invest directly in an index.

Past market experience is no guarantee of future results.

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