PZENA Investment Management

CATALYSTS FOR CHANGE

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Growth Expectations Come Back Down to Earth

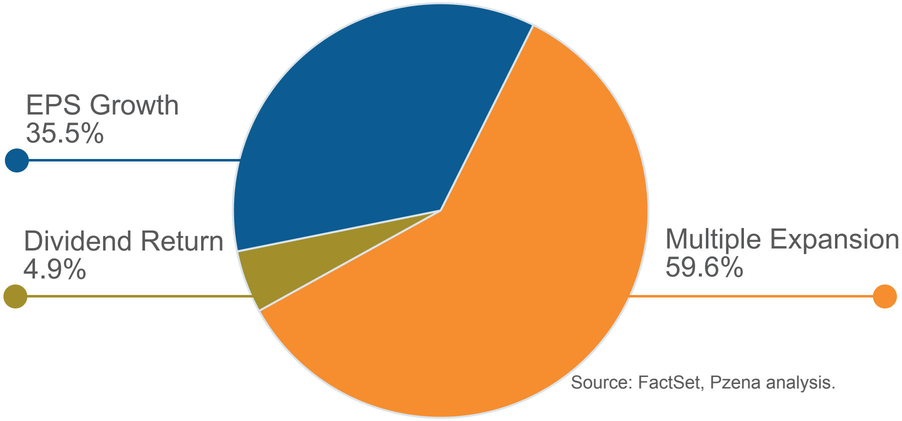
For many of the technology "masters of the universe," growth rate expectations (and stock prices) have been rising much faster than earnings.

Investors should wonder: *Where will that growth come from?*

EXAMPLE: MICROSOFT

Performance Drivers[1] for the Five Years Ended September 30, 2020

Earnings and dividends explain only 40% of the stock's total return over the past five years.



The remainder is a bet on future growth, yet cloud penetration is already about halfway to saturation[2].

Multiple expansion is not a sustainable source of return.

Confronting Saturation

As a company becomes bigger, it runs out of market share to take. The law of large numbers is immutable.

To justify many growth stock valuations today, one must believe:

- A company's revenues will far exceed what's visible today as an addressable market, OR
- That it can continuously expand beyond its core business, which rarely happens.

Any disappointment in the growth rate can translate into multiple contraction.

Sustained high earnings growth is rare.

Over the past 25 years, only 9.7% of companies[3] in the Russell 1000® Index delivered more than 5 consecutive years of 10% or better EPS growth, and fewer than 2%[3] achieved it for 10 consecutive years.

Source: FactSet, Pzena analysis.

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FURTHER INFORMATION

[1]Data as of September 30, 2020. Dividend and total return assumes dividends received and not reinvested. EPS growth is calculated using forward 12-month consensus estimates per FactSet for both starting and ending dates. As of September 30, 2020, Microsoft is not held in any of our strategy composites. Past performance is not indicative of future returns. [2]Market analysts estimate that cloud penetration of data needs has reached 30% – 35%, and that the possible maximum penetration for the cloud will be approximately 70%, therefore, we are about halfway to saturation. [3]Based on companies that were in the Russell 1000® index for a minimum of five consecutive years, and 10 consecutive years respectively.

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The Russell 1000 Index measures the performance of the large-cap segment of the U.S. equity universe. It is a subset of the Russell 3000® Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership.

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