MARKET COMMENTARY

EQUITY ANALYSIS

THE GROWTH HYPE AND VALUATION REALITY

There has been much discussion recently about growth. Artificial intelligence and other emerging technologies are fueling expectations for high returns, pushing stock values to record highs. While analysts forecast uninterrupted growth, we question whether some of these expectations are realistic. Markets appear to be pricing in very high growth assumptions, which may prove difficult to meet over time.

THE THREE PILLARS OF VALUATION

Three key factors drive valuations: opportunity cost, risk, and growth. Opportunity cost reflects the need for returns that exceed what can be earned in risk-free assets, such as U.S. Treasury bonds. Riskier assets demand a premium to compensate for their uncertainty. Finally, growth expectations influence the price investors are willing to pay—higher growth justifies higher valuations.

THE ALLURE (AND DANGER) OF ENDLESS GROWTH

As enthusiasm rises, it becomes easier to justify paying elevated prices by assuming endless growth. The higher the projected growth rate and the longer the time horizon, the more plausible such prices may seem. Today, the S&P 500 Growth Index trades at nearly 33 times next year's forecasted earnings — the highest valuation in 25 years (Chart A, page 3) — and 50% higher than the 22x multiple for the average Washington Crossing Advisors holding. Analysts project an average of 12% annual earnings growth for the next three years, according to Bloomberg data.

LESSONS FROM HISTORY: WHEN GROWTH COLLAPSES

However, history warns us that lofty growth expectations can quickly crumble. During the early 2000s and the 2007-2009 Financial Crisis, growth forecasts evaporated, and high-growth stocks lost significant value—some by 50-80%. By contrast, companies with low debt, stable franchises, and consistent profitability weathered these periods far better.

THE LIMITS OF GROWTH

It is also worth noting that no company can grow faster than the economy indefinitely. As firms grow larger, sustaining high growth becomes increasingly difficult. A recent Goldman Sachs study found that only 11% of companies with over 10% revenue growth maintained that rate for a decade, and just 3% of companies with 20% growth sustained that lofty rate. Over time, growth inevitably slows.

BEHAVIORAL BIASES AND THE GROWTH TRAP

Behavioral factors also play a part. When conditions are favorable, we tend to take a long-term view. When conditions deteriorate, patience fades, and short-term thinking prevails. A sudden slowdown or financial crisis often leads to rapid reductions in growth forecasts and a preference for near-term dividends over long-term potential. All of this is a surefire recipe for locking in losses at the most inopportune time.

THE RISK OF CHASING GROWTH

To illustrate the risks of focusing too heavily on growth, we analyzed the *implied long-run growth rates*[1] for S&P 500 stocks (Chart B, page 3). As expected growth increases, so does beta (risk). This correlation reflects the uncertainty inherent in growth projections and the sensitivity of long-term cash flows to interest rate changes—similar to the volatility seen in long-term bonds. Notice also that the WCA holdings tend to avoid some of the highest implied growth rates with the highest risk (beta) and cluster together more tightly than the index constituents.

GROWTH GROUNDED IN QUALITY

This is not to say growth is undesirable. Growth is a vital driver of equity returns. However, it must be grounded in durability and solidity—traits often found in companies with low debt, consistent profits, and reliable businesses. These qualities, which we call "WCA Quality," should form the foundation of any growth investment.

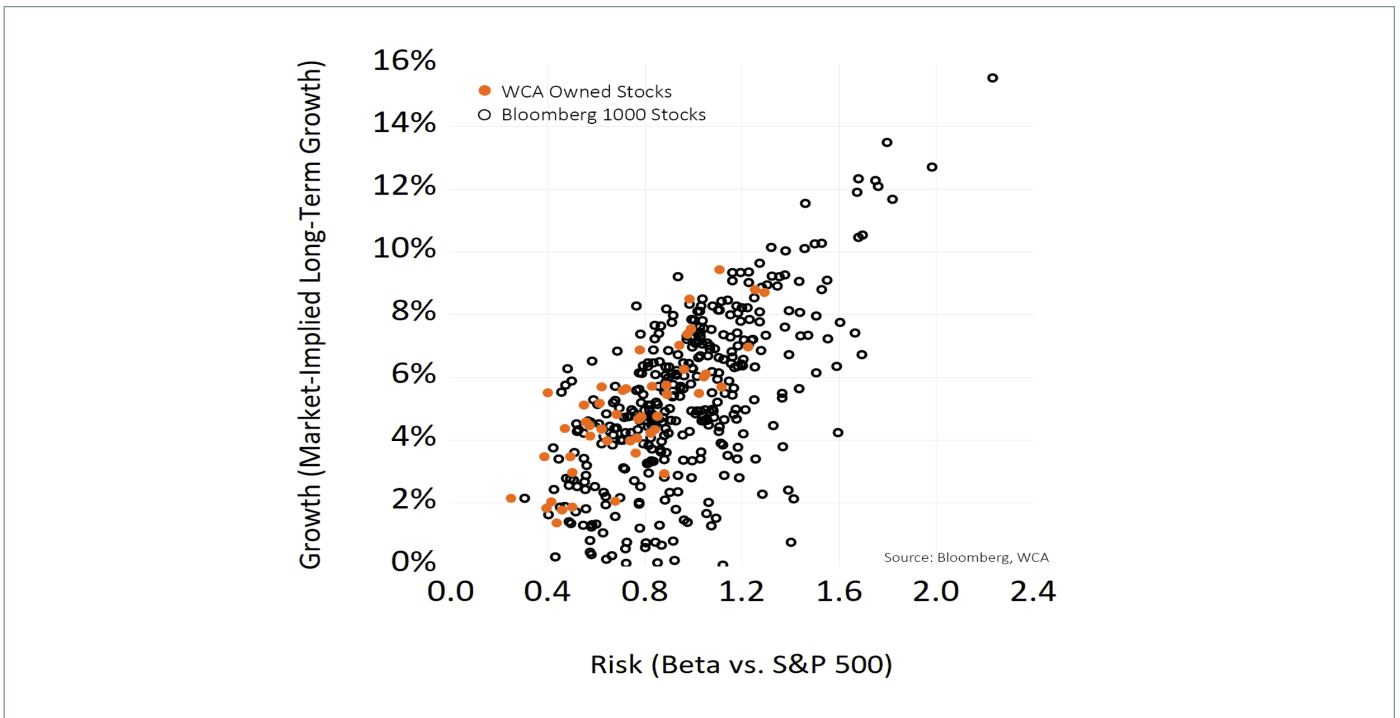
CONCLUSION

In the end, growth is an uncertain and sometime fickle variable that can change with the times. While high growth expectations can fuel enthusiasm, they can also create disappointment. By focusing on quality and durability, we can focus on a more enduring aspect of most businesses. This helps us navigate changing market conditions with greater confidence. The Washington Crossing Advisors approach is not about chasing fleeting trends but about investing in what lasts. Enduring success lies not in betting on boundless growth but in finding resilient businesses at reasonable prices—this is a discipline which has stood the test of time.

1. *Calculated using the Gordon Growth model.*

CHART A | S&P 500 GROWTH INDEX PRICE-EARNINGS MULTIPLE NEAR RECORD Source: WCA, Bloomberg

CHART B | HIGHER GROWTH IMPLIES HIGHER RISK Source: WCA, Bloomberg



IMPORTANT DISCLOSURES

Standard & Poor's 500 Index (S&P 500) is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market.

The S&P 500 Growth measures constituents from the S&P 500 that are classified as growth stocks based on three factors: sales growth, the ratio of earnings change to price, and momentum.

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All investments involve risk, including loss of principal, and there is no guarantee that investment objectives will be met. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager.

Beta is a measure of the volatility, or systematic risk, of a security or a portfolio relative to the market as a whole. A beta of one is considered as risky as the benchmark and is therefore likely to provide expected returns approximate to those of the benchmark during both up and down periods. A portfolio with a beta of two would move approximately twice as much as the benchmark.

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