Opportunities in Crossover Growth Investing

Market Insight

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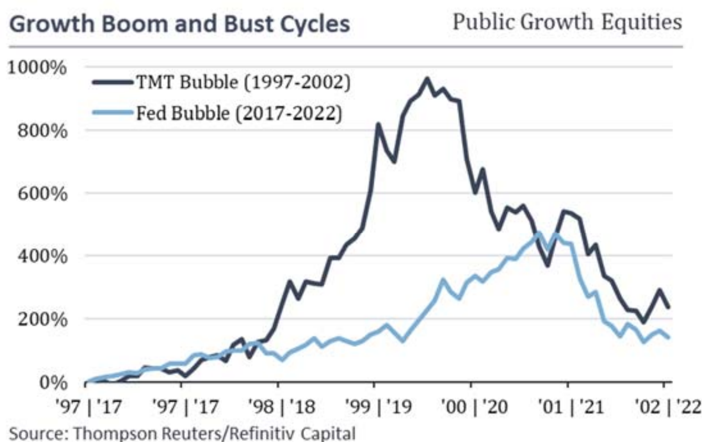
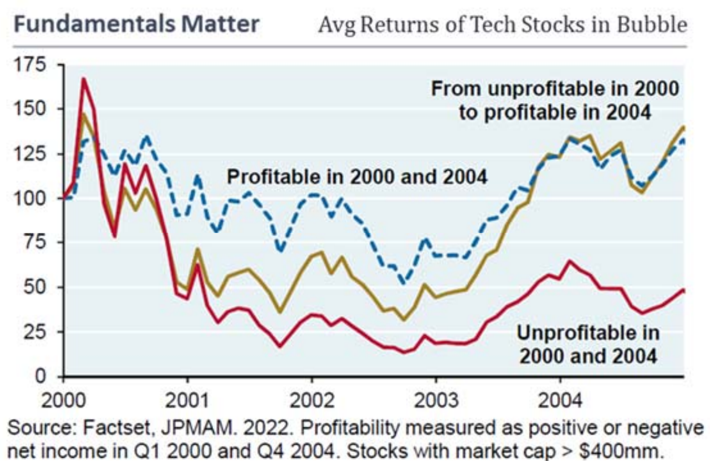
INTRODUCTION

Global equity markets have been on a turbulent path since early 2020, with companies in high growth sectors like technology and biotech at the center of the volatility. Supported by aggressive monetary stimulus that included zero rates and trillions of dollars in quantitative easing, growth companies enjoyed a decade-long bull market. In addition, a robust appetite for IPOs supported a boom in late-stage private fundraising resulting in substantial upside generated in both public and private markets. As valuations skyrocketed in some of the most speculative areas of the market and inflation hit 40-year highs in mid-2021, central banks began to signal a shift in monetary policy, triggering a sharp sell-off in late-2021 and 2022. This boom/bust cycle was reminiscent of the infamous dot-com bubble of the late-1990s, with significant fortunes made and lost over relatively short time horizons. Like the previous bubble, it is reasonable to assume that many companies in the current cycle may never recover. However, history also suggests that the potential for a significant recovery exists for growth companies that can withstand short-term headwinds, gain market share from weaker competitors, and rise from the ashes.

At this point in the cycle, many of the forces that pressured growth stocks in the past couple of years have worked their way through capital markets. Interest rates are closer to peaking than bottoming, and valuations have reset meaningfully across public and private markets. Moreover, the pace of technological innovation continues unabated and the potential for massive value creation across sectors remains significant. As a result, the opportunity set for fundamental growth investors is much more favorable today. Crossover investors, with the ability to deploy capital across public and late-stage private companies, have seen the pendulum shift back in their favor after years of a seller's market. However, like the market's recovery after the bursting of the internet bubble in 2000, we do not believe this will be a universal recovery for all stocks. Stock selection and the ability to differentiate between "the haves and have nots" will be critical to generating returns going forward.



Source: Thompson Reuters/Refinitiv Capital



Source: Factset, JPMAM. 2022. Profitability measured as positive or negative net income in Q1 2000 and Q4 2004. Stocks with market cap > $400mm.

While we believe that the current opportunity set in growth companies is undeniably favorable, capturing this recovery will require domain expertise within specific industries (regardless of company listing status). In our view, crossover strategies, and the flexibility they offer, are best equipped to identify the future winners and losers. Recently we have had a number of interesting conversations with our managers which have underscored the highly attractive setup for growth investing today. We highlighted several of these exchanges below which address some of the most exciting areas of the growth universe such as Artificial Intelligence (AI), Software, and Biotechnology.

AI REVOLUTION: GAVIN BAKER, PORTFOLIO MANAGER AT ATREIDES MANAGEMENT

How does Artificial Intelligence (AI) compare to recent technological advancements?

Generative AI or "GenAI" is not Crypto. It is not Web3. It is not the Metaverse. It is the first fundamentally new development in technology since the advent of cloud computing ten years ago and the iPhone sixteen years ago. The combination of these two technologies created trillions of dollars of value for mega cap tech companies over the last decade and is a reason why trying to

outrun mega cap tech over the last decade was so difficult. Although there is an undeniable hype cycle, we view GenAI as a game changer with the potential to change the structure of our world across multiple axes, including healthcare, media, education, and many others.

How is AI impacting the current tech investment landscape?

GenAI has the potential to fundamentally reshuffle the competitive deck for mega cap tech companies. The competitive environment in tech and overall trends were relatively stable for the decade ending in 2022. Google, Facebook, Apple, Amazon, Netflix, and Microsoft generally stayed in their own swim lanes and if they did compete it was well-defined and oligopolistic such as in cloud computing. GenAI changes all of this and we believe it will reward first principles thinking as it comes to stock selection. Almost all mega cap tech equities are now facing both existential risk and opportunities from AI. Just as cloud computing disrupted almost every legacy technology company ranging from Cisco to EMC to Hewlett-Packard, GenAI could disrupt the mega cap tech companies.

What are the most interesting GenAI investment opportunities?

Semiconductors and deep infrastructure technology have historically been strong performers early in the lifecycle of fundamentally new technologies, both because they are the "picks and shovels" essential to building out the new technology and because the application layer winners are not yet clear. GenAI is likely to follow a similar path with hard technology leading in the early days because they have the most direct financial upside because of the requisite infrastructure buildout. I have been investing in semiconductors and deep infrastructure technology for over 20 years, both publicly and privately. I strongly believe cumulative domain knowledge will be a competitive advantage with regards to picking the right GenAI investments for the foreseeable future.

Staying close to the most cutting-edge research and making the right investment decisions based on the almost weekly advances in this technology will be critical. Being a crossover investor is fundamental to successfully tracking these advances across venture-backed GenAI companies – and perhaps even more so across the venture-backed semiconductor, hardware and software companies that are enabling GenAI. Not only does a crossover approach offer investors the flexibility to seek value across stages – whether in public semiconductor names today or in emerging infrastructure software tomorrow – from our perspective it provides critical insights to inform investment decisions in both publics and privates.

VALUATION RESET IN SOFTWARE: JOHN WOLFF, PORTFOLIO MANAGER AT INSIGHT PARTNERS

Software valuations increased rapidly during COVID and then corrected in 2022. Where do we stand today?

While every business experiences ebbs and flows in customer demand, in our view software is the most economically resilient and intrinsically the highest margin sector in the market. We believe that software as a sector is structurally and secularly advantaged - we are still in the early innings of a digital transformation that will revolutionize the way global businesses operate and use data. We anticipate that this will create durable growth for years to come for many of today's top technology businesses, as well as for ones that have not yet been founded.

If you boil down our approach to capital allocation, we hold two simple views that span cycles: 1) we believe that the companies we invest in have the power to generate substantial future free cash flow that is not reflected in current valuations, and 2) we believe that top-line trends in our holdings are much more durable than market participants currently think. The biggest challenge in software investing over the last two years was valuation, which peaked at ~17.5x NTM sales during 2021. While growth has slowed since then, absolute growth rates in our portfolio have remained strong and valuations have corrected by over 60%. In addition, many company CEOs have right sized their cost structures, leading to substantial improvements in profitability and free cash flow. We believe this creates a much more favorable backdrop to put our dollars to work.

In the period 2020 – 2022, there were very few stock-specific "debates" – correlations in technology (and other sectors) were high. However, in a world without material monetary stimulus, dispersion has come back into the market. In the last two months of 2022 and all of 2023, differentiation and "debates" have returned, as evidenced by the spread between companies such as NVDA and META vs. the Nasdaq more broadly. In addition, Generative AI has created a number of new "product cycles" within technology, which makes it even more important to understand new innovations in both the public and private markets. To us, this means back-to-basics, bottom-up stock underwriting gives investors the best chance to make outsized returns.

How did valuations in the private market hold up, and where is the best opportunity now, public or private?

While private valuations have not corrected to fully reflect the public markets, we have been seeing signs over the past six months that this is beginning to change. Our crossover approach allows us to gather insights from companies at all stages of their lifecycle, allowing us to shift focus to where we believe the opportunities and IRRs are greatest through our "single pane of glass" approach.

Over the past year, we have focused our attention largely on the public markets as late-stage private company management teams were slow to adjust their valuation expectations. Additionally, late-stage private companies that raised during the 2020-2021 period were flush with cash and thus raising was not necessary. Companies were content to wait until valuations were more appealing. Now that we are more than a year into this correction cycle, we are starting to see that dynamic shift. The secondary market supports this view, showing that in aggregate common shares are continuing to decline in value while the preferred shares have begun to stabilize.

The best private companies today are still growing a high rate - in some cases, well above their public market peers. As companies approach two years since their last capital raise, they are beginning to test the market with more reasonable pricing expectations. Given the pipeline we see today, we anticipate that the private markets will represent an attractive investment opportunity over the next six to twelve months. The sourcing engine at Insight covers the entire private technology landscape, and we are confident that Insight's ~600 portfolio companies will provide ample opportunities as new funding rounds begin to materialize.

BIOTECH BOOM AND BUST: ANDY ACKER, PORTFOLIO MANAGER AT JANUS HENDERSON INVESTORS

Explain your 90/90 rule and how it influences your approach to investing the biotech?

The 90/90 Rule is a concept developed by Janus Henderson Investors. The basic premise is derived from the fact that approximately 90% of drugs that enter human clinical trials never make it to the market. In addition, from our experience, 90% of the time consensus estimates for new drug launches are WRONG. This combination leads to a high failure rate of biotech companies, and upside coming from a relatively small proportion of the universe. We believe our ability to successfully identify winners on both the clinical and commercial side of the 90/90 rule allows for a better outcome relative to market indices such as the XBI and NBI, which are forced to absorb weak performance from the large universe of "have nots" that fail to live up to expectations.

With biotech indexes still over 50% below 2021 peaks, where are the best areas of opportunity today?

Despite the 60%+ drawdown of the XBI since February 2021, the recent environment has been ideal for stock picking in biotech, as the drawdown offered excellent opportunities to own select companies at cheap prices, while continued poor performance of lower quality companies have limited the index recovery. During the growth sell-off, we were able to increase our allocation to public biotech at significant discounts. Now that we're through the worst of the drawdown, we are increasingly seeing very attractive crossover investing opportunities on the private side which has led to increased deal activity for the fund year to date.

What does the opportunity set look like in the private space today?

The opportunity set for investments on both the public and private side for our fund continues to be driven by strong innovation across the biotech sector. On the private side, we have deployed capital into attractively valued companies with strong clinical data and near-term catalysts in both oncology and obesity. We have also seen our private companies increasingly able to access the public markets, either through traditional IPOs or reverse mergers. M&A activity has also been driving returns. Many public companies that have been delivering clinical trial successes have seen their stocks soar, and many firms (both private and public) have also become acquisition targets. But unlike in years past, when "mega deals" dominated, these days "tuck-in" acquisitions of small and mid-size companies with clinically de-risked pipelines are more common. We believe this type of M&A activity should continue, given robust innovation, still-attractive valuations, and looming patent-cliffs for major pharma firms.

CONCLUSION

The years following the Great Financial Crisis were defined by low interest rates, direct monetary stimulus, and abundant liquidity. Fast-growing companies were one of the most highly rewarded cohorts in this decade, benefiting from unlimited funding at ever-rising valuations. Aggressive central bank hikes in 2022 triggered a severe correction in valuations and capital availability in both public and private markets. With rates peaking and valuations resetting, the opportunity set for investors today is far more attractive than it has been in years. In public markets, one can find high quality companies with above market growth rates at below market valuations. In private markets, well connected investors with expertise and cash available to deploy can take advantage of discounted valuations in the growth equity market at investor friendly terms.

The emergence of crossover investing has expanded the universe for specialized growth managers by allowing them to allocate capital across the best opportunities in both public and private markets. The ABS team has a 30-year history investing with domain experts and building diversified portfolios of sector specialists. We believe these managers are well positioned to take maximum advantage of the current market environment and have constructed a diversified, growth-oriented, crossover portfolio with the potential to deliver high returns and meaningful alpha.

BIOGRAPHIES

Gavin Baker

Gavin Baker is the Managing Partner and Chief Investment Officer of Atreides Management, LP. Prior to founding Atreides in 2019, Gavin was at Fidelity Investments from 1999 – 2017, most recently as the portfolio manager of the Fidelity OTC Fund from 2009 – 2017. The $17 billion Fidelity OTC Fund outperformed 100% of its Morningstar peers and won 6 Lipper awards over Gavin's 8-year tenure as portfolio manager. Gavin was the Boston Globe's Fund Manager of the Year in 2014 and his performance was recognized by articles in Barron's, the New York Times, Investors Business Daily and the Wall Street Journal. He helped spearhead Fidelity's venture capital investing and was a board observer at Nutanix, 23andME, Jet.com, AppNexus, Dataminr and Roku, among others. Gavin earned an AB in economics and history from Dartmouth College.

John Wolff

John Wolff is a Managing Director and the Chief Investment Officer of Insight Partners Public Equities (IPPE). Prior to Insight, John worked at Omega Advisors as the Head of Technology Investing as well as a Portfolio Manager alongside Leon Cooperman from 2015 to 2020. Before joining Omega, John was a Principal at Andor Capital from 2012 to 2015. John started his career in finance at Goldman Sachs in its TMT Investment Banking Division after successfully exiting the internet start-up he co-founded. John graduated from Harvard College in 2007 with a degree in Psychology and received his MBA from Columbia Business School in 2010.

Andy Acker, CFA

Andy Acker is a Portfolio Manager at Janus Henderson Investors responsible for managing the Global Life Sciences and Biotechnology strategies since 2007 and 2018, respectively. He also leads the firm's Health Care Sector Research Team. Mr. Acker was assistant portfolio manager on the Global Life Sciences strategy from 2003 to 2007. He joined Janus in 1999 as a research analyst focused on companies in the biotechnology and pharmaceutical industries. Prior to this, he worked as a strategy consultant for the Boston Consulting Group and as a health care analyst for Morgan Stanley Venture Partners. Mr. Acker received his Bachelor of Science degree in biochemical sciences from Harvard University, graduating magna cum laude and Phi Beta Kappa. He also earned an MBA with honors from Harvard Business School. Mr. Acker holds the Chartered Financial Analyst designation.

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