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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Adding a Value Component to Growth Investing

M. SCOTT THOMPSON, CFA, is Managing Principal and Chief Investment Officer at Montag & Caldwell. He joined Montag in 1992 upon graduating from the University of the South with a B.A. in Economics. He held the role of Director of Research from March 2017 to November 2020, and of Co-Director of Research from June 2009 to March 2017, before being appointed CIO in November 2020. Mr. Thompson received his MBA from Emory University. His professional affiliations include the CFA Institute, as well as the CFA Society Atlanta, where he is a former Trustee.

JAMES M. FRANCIS, CAIA, is Managing Principal and Director of Marketing at Montag & Caldwell, LLC. He joined the firm in 2001. Previously, he served as a Portfolio Strategist for First Union National Bank (Wells Fargo). Mr. Francis provides clients, prospects, and other intermediaries detailed information regarding the investment philosophy, process, and holdings specific to Montag's investment strategies. Mr. Francis' professional affiliations include the Chartered Alternative Investment Analyst Association. He received his B.A. from Duquesne University and MBA from The University of Georgia.

SECTOR — GENERAL INVESTING

TWST: Let's start off with an overview of your company for our readers, a snapshot of the business and what characterizes your overall investment approach.

Mr. Francis: Montag & Caldwell started in Atlanta, Georgia, in 1945. It's actually one of the oldest asset management firms in the Southeast. Over our 75-plus years, we've had the privilege of working with both individuals and institutional investors.

Our process emerged out of the mid-1970s bear market, and the biggest lesson for us during that time period was to focus on capital preservation as a risk management priority.

This really gave birth to our valuation discipline, and our valuation discipline is simply understanding the intrinsic value of each of the companies that we research and consider. We want to make sure we own or invest in those companies at a discount to that intrinsic value.

We've used this approach — we've institutionalized this approach, really — in all of our thinking, and we've been doing that for going on 50 years now. Oftentimes, people describe us as a GARP manager — growth at a reasonable price.

We also emphasize in all of our portfolios very high-quality companies. Our client base today remains diverse, but admittedly we're getting a lot more interest from high net worth investors, given the higher quality profile, lower risk in terms of our valuation discipline, and, of course, our long-term track record.

TWST: Specific to your Large Cap Growth strategy, which we're focusing on today, what's important to know? What might differentiate it from similar portfolios?

Mr. Francis: I think what really makes us stand out is that a lot of growth managers end up overpaying for growth, particularly the more aggressive, momentum-oriented managers. So, growth managers either overpay for earnings growth or, conversely, they don't pay attention or don't appreciate stable, consistent and steady growth.

Our discipline is designed to avoid overpaying for growth, and to find those companies that demonstrate stable, steady, consistent growth, that are oftentimes undervalued by the market.

And as you would imagine, oftentimes when investors are chasing growth at any price, they avoid or they underappreciate to an even greater degree that steady growth orientation — the high-quality growth that we like. And so, that enables us to outperform over market cycles. We have a lot less volatility and a much more consistent approach around valuing high-quality earnings growth.

Mr. Thompson: I would say more simply, we employ a very low-risk growth approach where we're looking to invest in high-quality

growth companies that are attractively valued and that are growing their earnings faster than the market.

It's that valuation component of the discipline that James was highlighting that we think probably distinguishes us from other growth managers that tend not to pay as much attention to valuation. It's centered on a risk-control philosophy, where we're trying to minimize the risk for our clients.

We look to identify companies that have distinguished themselves with industry-leading products or services that are supported by some sort of proprietary technology or intellectual property. They have a strong brand. And they also enjoy superior scale and cost advantages that enable that company to deliver and defend high profit margins and high returns on investment.

When we marry that with proven management teams, strong balance sheets, and robust free cash flow generation, that lends confidence into those companies being able to sustain growth and the success of the business for a long period of time, and that's what we're looking for.

We think the three of those combined should drive continued upward revisions in revenue, profit margins, and earnings and free cash flow through next year and beyond. And, at the same time as that accelerating earnings growth, the stock is attractively valued on our work, selling at less than 90% of our estimate of fair value.

So, that's one name that jumps out at the top of the list in terms of names that we like at the moment.

Another one that I would highlight is **Netflix** (NASDAQ:NFLX), another name that we've owned for some time. It's got, again, a combination of reasonable valuation and accelerating earnings momentum.

What excites us in particular about **Netflix** is this opportunity for them to better monetize the roughly 100 million users that they've identified that previously were not paying for the service. They were essentially free riding, if you will.

And so, through the combination of introducing paid sharing at the same time as rolling out a lower priced, ad-supported tier, we think that there's now potential for them to show both accelerating subscriber growth and average revenue per user.

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TWST: So, is stock selection primarily how you mitigate risk? Is there anything else you'd add to that?

Mr. Thompson: Yes. We are definitely a bottom-up manager. Certainly, we spend a lot of time looking at, analyzing the macro environment, because no company, no industry, operates within a vacuum. But we build our portfolios from the bottom up by identifying high-quality growth companies that are attractively priced relative to our estimate of their intrinsic value, and that are showing accelerating earnings strength relative to the broader market.

And so, the valuation component is the precondition of investing in a company, and the accelerating earnings momentum is the timing catalyst, if you will.

The goal of this is that we would expect, over a full market cycle, that we will be able to keep up with the market averages during up markets, but provide our clients superior downside protection in down markets.

TWST: Can you tell us about a few of your favorite investment ideas right now, and how they illustrate what you're looking for in a holding?

Mr. Thompson: There are three stocks I'll share with you that I think clearly demonstrate our approach and our discipline. The first would be **Amazon** (NASDAQ:AMZN), which we've owned for a while now, but we're particularly excited about **Amazon** right now because we see positive inflections in three components of their business.

One is improving profitability of their retail operations due to cost rationalization efforts and increasing scale in their fulfillment centers. Secondly, within their AWS Cloud Services, we're seeing a positive inflection in demand as traditional workload optimizations start to wane, at the same time, gen AI engagements start to ramp. And then lastly, they've got a growing advertising business on their platform.

When you combine that with the fact that all their streaming competitors are in the process of retrenching in order to get to profitability much sooner, that means that **Netflix** is likely to show accelerating revenue, expanding profit margins, and strong earnings and free cash flow growth, much like **Amazon**, and again, it's reasonably priced on our work.

1-Year Daily Chart of Netflix Inc.

Chart provided by www.BigCharts.com

The third name that I would highlight as a good example of our discipline and approach would be **S&P Global** (NYSE:SPGI), which we began acquiring earlier this year on the prospect of a cyclical recovery in debt issuance.

We saw a downturn in debt issuance in 2022, particularly as interest rates started rising, but we think we're on the cusp of that reversing course, particularly with what appears to be a wall of global

corporate refinancing ahead of us in 2024 and 2025. That should boost their ratings business.

At the same time, we're still anticipating a lot of additional cost and revenue synergies that can be had from their combination with IHS Markit, which they acquired a couple of years ago.

And then lastly, we also see a potential burgeoning stealth AI play within **S&P Global**, in the form of their ability to leverage these massive and highly proprietary data sets that can be used to feed into these large language models to create unique and differentiated vertical-specific industry insights that they can charge a premium for.

We expect this to lead to above-average earnings growth relative to the rest of the market, and again, it's very attractively valued in relation to our estimate of intrinsic value.

So there's been a huge, historic concentration of returns this year amongst a small handful of names. Again, I think that exemplifies this crowding nature of investors into a handful of relative safe havens, and that very well could continue for a while longer.

At some point we would expect there to be a mean reversion, where the rest of the market catches up. However, that may not happen until it's confirmed that we've entered a recession and the Fed has shifted to an easing posture — at which point investors will begin to position for the subsequent economic recovery, which should, at that point, then lead to a broadening out of the market.

In light of that, over the last year, believing that we've entered late cycle, we have increasingly shifted the portfolio more defensively in favor of higher-quality names with less economic sensitivity.

"Beginning a year, year and a half ago, we started selling, exiting a lot of more economically sensitive names, like within the semiconductor and electronic component and equipment space, and replaced those with more durable, defensive growth names within software, consumer staples, health care, those types of names."

So, those are three names that I would highlight as names that we like and that exemplify our process and our discipline.

TWST: Is there anything you would add about your ongoing portfolio management? What might prompt a reduction to or a complete exit from a holding?

Mr. Thompson: On that second question, we would exit a position if we saw a deterioration in earnings growth that we believe is not temporary or transitory, in other words, one quarter or two, but something that's likely to be more enduring. That would trigger a reduction or an outright sale.

Similarly, if the stock appreciated to a value well in excess of our estimate of fair value. Within that context, we draw a line at 120% of fair value as the level where we force ourselves to take action to significantly trim or sell outright a position, because it's just gotten to a valuation level that is unlikely to be sustained, in our view, based on the anticipated earnings growth.

So, those two — excessive valuation and/or a deterioration in earnings growth over the near to intermediate term — would trigger an exit from a particular position.

In terms of the broader positioning of the portfolio, in our view we're in the latter stages of the current economic cycle. And typically when you're late cycle, that's a time period that's marked by growing economic uncertainty and certainly rising fears of recession, which leads investors to increasingly congregate amongst a shrinking number of higher-quality growth stocks that are less dependent on the economy to sustain growth.

We think this has been clearly exemplified this year by the extraordinary outperformance of The Magnificent Seven, which is comprised of **Amazon**, **Apple**, **Alphabet**, **Meta**, **Microsoft**, **Nvidia** and **Tesla**. Those seven stocks, year to date through yesterday, are up 82% collectively. That compares to the S&P 500 excluding those seven names, which is up just 6%.

Beginning a year, year and a half ago, we started selling, exiting a lot of more economically sensitive names, like within the semiconductor and electronic component and equipment space, and replaced those with more durable, defensive growth names within software, consumer staples, health care, those types of names.

1-Year Daily Chart of S&P Global Inc.

Chart provided by www.BigCharts.com

Right now, we're overweight in health care, communication services and consumer discretionary; we're underweight more cyclical areas like technology, energy and industrials; and we're more or less in line or have equal weights in staples, materials and financials.

TWST: When would you see that perhaps shifting?

Mr. Thompson: Like I said, I think that will likely start to change once it's confirmed we've entered recession and the Fed makes a decisive pivot towards easing. Right now, the Fed is professing a higher-for-longer policy stance. I think most investors rightly believe the Fed has likely finished hiking interest rates. We would agree that if they're not finished, they're very close to being finished.

What concerns us, though, is what comes next. And we're concerned about the lag effects of all the monetary tightening over the past 18 months, the impact that that cumulative tightening will have on the economy and economic activity.

The consensus seems to be that the Fed has successfully engineered a soft landing, that the economy will continue this gradual glide path to more moderate growth and lower inflation, which very well could happen. It's possible, but it's not probable in our view.

And the reason is, history has shown that, for one, it's very difficult for the Fed to perfectly time its withdrawal of restraint, which is why the Fed has such a terrible track record of actually delivering soft landings.

What typically happens is, it looks like we're on this gradual glide path to a soft landing, which a lot of times leads to people saying, well, this time is different. But, as we've seen many times, it's OK until it's not.

Because what typically happens is, as the economy gets more and more fragile due to monetary tightening, inevitably there's some sort of exogenous shock or financial crisis that emerges that ultimately pushes us over the edge, and therefore prevents that fairytale ending of the soft landing that everyone seems to believe and expect right now.

TWST: Well, the Fed's actions is certainly one example, but what other broader, macro factors or indicators do you keep a close eye on, or are particularly top of mind today?

Mr. Thompson: I'm sure like most others, we are looking for signs, evidence that we are entering recession, because that is, obviously, the key factor that will influence the market from here.

We have observed a growing number of recession signals over the past year, everything from the inverted yield curve, which a lot of people have been noting for some time; declining leading economic indicators; declining money supply, which hasn't happened since the Great Depression; tightening bank credit as reflected in the Senior Loan Officer Opinion Survey, banks are pulling back on credit.

And then it looks like we could be close to triggering one additional recession signal, which is the Sahm Rule. That is named after the former Fed economist, Claudia Sahm, and it says that whenever there's been a 50 basis point increase off the cyclical low for the three-month moving average of the unemployment rate within a 12-month period, every single time that's happened in history, we've entered recession.

We're about two-thirds of the way there at the moment, and if unemployment keeps rising — it's already moved up to 3.9% off of an absolute low of 3.4% — then that three-month moving average will move higher, and again, that would be another recession signal.

In the meantime, we continue to watch the initial jobless claims every week to see if there's any evidence of mounting job losses. Right now, the initial claims have gone essentially sideways for the past year or two, indicating that there hasn't been meaningful layoffs. But continuing claims have been rising now for several months, indicating that, at a minimum, it's becoming harder for those who have lost their job to find new employment. So we're continuing to watch the initial claims.

Another metric that we're watching closely is credit spreads, which for quite some time have remained fairly benign. But when those credit spreads start to blow out, that will be a clear sign of distress, and likely evidence that we're entering a recession.

TWST: What should investors be thinking about at this point in time in terms of adding or adding to an exposure to growth stocks, and especially large-cap growth stocks?

Mr. Thompson: We think we're at the opportune time in the cycle for growth, and particularly large-cap high-quality growth. But beyond that, as James indicated at the outset, we feel confident that our process and our discipline will add value for our clients over a full market cycle.

We have the ability to shift the portfolio based on where we think we are in the cycle. In other words, once we are in recession and the Fed does pivot to an easing bias, we will likely begin to shift the portfolio down the market cap spectrum, along with more economically sensitive issues, but they'll still have the same characteristics that we look for in all the companies we invest in: They're undervalued relative to our estimate of intrinsic value, and they're showing relative earnings strength.

As long as we do that, we think we can be an all-weather manager.

TWST: Would you wrap up with some final thoughts on your outlook for 2024 and advice for our readers?

Mr. Thompson: I'll conclude with, there's this consensus view that the Fed has successfully engineered a soft landing, but we still think that there are some risks ahead. Namely, that stocks, at least on our work, are fully valued with increasing consumer headwinds; rising geopolitical risks; growing political uncertainty now that we're entering a new presidential election cycle; and 2024 earnings estimates are at risk, particularly if we do enter recession, which we still think is probable in 2024.

We think that the market as defined as the S&P 500 is range bound for the time being, call it a wide range of 3,600 to 4,600. Right now, we're closer to the top end of that range, and so we would say the market's range bound with downside risk, particularly if recession does appear in 2024. So we would advise caution, defensiveness, high quality, large cap and growth.

TWST: Thank you. (MN)

M. SCOTT THOMPSON, CFA
Managing Principal & Chief Investment Officer
JAMES M. FRANCIS, CAIA
Managing Principal & Director of Marketing
Montag & Caldwell, LLC
(404) 836-7100
www.montag.com

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Principal risks associated with Montag & Caldwell's Large Cap Growth strategy include: • Growth Stock Risk – These stocks may be more sensitive to market movements because their prices tend to reflect investors' future expectations for earnings growth rather than just current profits. • Sector Risk - To the extent the strategy has substantial holdings within a particular sector, the risks associated with that sector increase. • Foreign Investment Risk – From time to time, the strategy may invest in U.S. registered ADRs and foreign companies listed on U.S. stock exchanges which involve additional risks that may result in greater price volatility. • Liquidity Risk - The strategy may not be able to purchase or dispose of investments at favorable times or prices or may have to sell investments at a loss. • Market Risk—Market prices of investments held by the strategy may fall rapidly or unpredictably due to a variety of factors, including changing economic, political, or market conditions, or other factors including war, natural disasters, or public health issues, or in response to events that affect particular industries or companies.

The S&P 500 Index is an unmanaged index commonly used as a benchmark to measure U.S. stock market performance and characteristics. An investor cannot invest directly in an unmanaged index.

Past performance is not a guarantee of future results.

TERMINOLOGY:

• Bottom-Up – This investment approach emphasizes research of individual company stocks and those companies' fundamentals, with less emphasis on broader industry, sector and economic factors.
• Credit Spread – The difference in yield between bond/debt securities of the same maturity but of different risks and credit quality ratings. Often used as an economic indicator with widening credit spread suggesting a worsening economic outlook and narrowing credit spread suggesting an improving economic outlook.
• Earnings Growth – A fundamental factor about a company that can assist investors evaluate the health of the business, how fast the company's profits are growing over a particular time period, as well as the company's potential stock market performance.
• Fed – The Federal Reserve Board
• Intrinsic Value – A proprietary calculation of the current or anticipated value of a company's stock based on proprietary research and analysis. Intrinsic value differs from the current market value of the stock as represented in the broad market.
• Inverted Yield Curve – Occurs when short-term interest rates on bonds are greater than long-term interest rates. Often used as an economic indicator signaling the potential for an economic recession.
• Styles of Investing:
  • Growth – An investment approach that emphasizes investment in stocks of companies that have strong earnings growth.
  • Value – An investment approach that emphasizes investment in stocks of companies that appear to be undervalued by the broader marketplace, based on the investor's proprietary research and analysis.
  • GARP – Growth at a reasonable price. An investment approach that seeks to combine the aforementioned aspects of both the growth and value investment styles.

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