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PERSPECTIVES

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Quality Growth, ex-Growth?

The Growth Has Bled Out

For much of the post-Global Financial Crisis period, quality growth investing occupied a privileged position within institutional portfolios. The proposition was straightforward: invest in businesses with durable competitive advantages, high margins, strong returns on capital, recurring revenue streams, and predictable cash flows. Over time, the compounding of superior business economics would overwhelm short-term market volatility.

The approach attracted significant investor capital. Quality growth strategies often delivered a compelling combination of growth, resilience, and lower volatility than many traditional growth strategies. For many asset owners, quality growth became the "sleep-at-night" component of their equity allocation.

However, a curious shift appears to have occurred in recent years. Many of the sectors and companies that historically exemplified traditional quality growth characteristics have experienced a meaningful slowdown in growth, even while many of their traditional quality characteristics have remained intact.

The result is an important question for investors: has the relationship between quality and growth changed?

When Quality and Growth Diverge

For much of the last decade, quality and growth often went hand in hand. Many of the market's strongest growth companies also exhibited the characteristics traditionally associated with quality investing: high margins, strong returns on capital, recurring revenue streams, stable earnings, and asset-light business models.

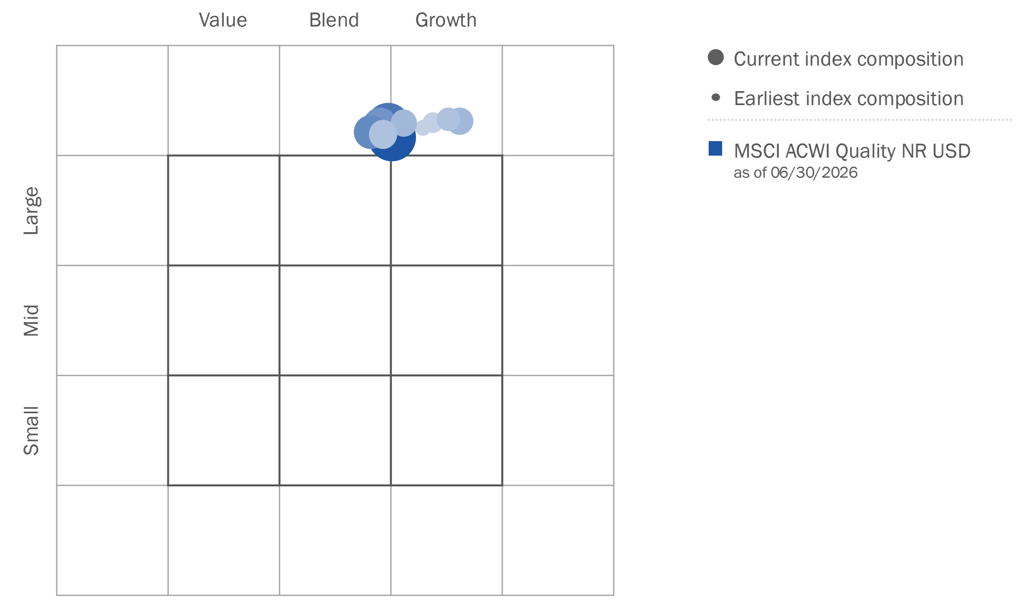
The success of these businesses was not accidental. Software companies, consumer franchises, and select healthcare businesses often benefited from powerful secular tailwinds while simultaneously exhibiting many of the characteristics traditionally associated with quality investing. Strong growth supported margins and returns on capital, while high profitability provided the resources necessary to sustain innovation, market leadership, and competitive advantages.

This combination created a powerful feedback loop. Companies with superior economics often became stronger over time, reinforcing both their quality and growth characteristics. As a result, quality became an increasingly effective lens through which to identify attractive growth opportunities. In many respects, quality served as a useful proxy for future growth. Investors did not necessarily have to choose between the two because the market's most successful companies frequently exhibited both.

More recently, however, the relationship has become less straightforward. Some of the sectors that historically exemplified quality growth characteristics have experienced slower growth, while many of today's most compelling growth opportunities exhibit characteristics that differ meaningfully from the traditional quality framework.

The Growth Has Slowly Bled Out of Quality

Trailing 3-year index composition: MSCI ACWI Quality (the larger the circle, the more recent the time period)



Trailing quarterly three-year returns as of 6/30/2026.

Source: MSCI. The MSCI ACWI Quality Index is designed to capture the performance of companies across developed and emerging markets that exhibit high-quality fundamentals. It emphasizes firms with strong profitability, stable earnings, and conservative financial leverage.

In the chart above, the larger circles represent the composition of the MSCI ACWI Quality Index as of more recent quarter-ends (i.e., the larger the circle, the more recent the time period, and the smaller the circle the farther away the time period). As the chart shows, over the trailing three years the quality index has slowly migrated away from growth characteristics and toward the value end of the spectrum. In other words, the growth has slowly bled out of quality and managers who remained focused on backward-looking growth characteristics have sacrificed forward-looking growth in the process.

The Opportunity Set Has Changed

Part of the explanation may lie in the changing nature of the opportunity set itself.

Historically, many of the market's most successful growth companies were asset-light businesses that benefited from network effects, recurring revenue streams, and attractive unit economics. Software companies, internet platforms, consumer franchises, and select healthcare businesses often required relatively modest levels of capital investment while generating substantial cash flow and high returns on capital.

Today's investment landscape appears different.

The buildout of generative AI infrastructure has created significant demand for semiconductors, datacenter infrastructure, networking equipment, power systems, electrical components, cooling technologies, and other enabling technologies. These businesses are critical to supporting the rapid adoption of artificial intelligence across the global economy.

Importantly, many of these businesses look quite different from the companies that dominated the previous decade. They are often more capital intensive, operate with lower margins than traditional software companies, and exhibit earnings profiles that can appear less predictable. In many cases, they are choosing to reinvest aggressively rather than maximize near-term profitability.

Traditional quality metrics were developed to identify businesses that had already achieved economic maturity and demonstrated sustained profitability. During periods of stability, these metrics can be highly effective. However, during periods of significant technological change, some of the most attractive opportunities may emerge in businesses that are investing heavily to capture future growth rather than optimizing for current profitability.

The current AI investment cycle illustrates this dynamic. Much of the value creation is occurring within the physical infrastructure required to support AI adoption. Datacenters require semiconductors, networking equipment, electrical systems, power management, cooling solutions, and other enabling technologies. The companies providing these solutions may not always score as highly on traditional quality measures, yet they are benefiting from some of the strongest secular growth drivers in the market. This does not diminish the importance of quality. Rather, it highlights the limitations of relying too heavily on any single framework. Traditional quality metrics remain valuable tools, but they may not fully capture the companies best positioned to benefit from major shifts in technology, infrastructure, and capital investment.

As a result, investors relying primarily on traditional quality metrics may underappreciate parts of today's evolving opportunity set.

Where Did the Growth Go?

The slowdown in growth did not occur in a vacuum. Many of the sectors that historically produced businesses exhibiting traditional quality growth characteristics have experienced a meaningful moderation in growth over recent years.

Consumer franchises provide one example. For much of the past two decades, global consumer and luxury brands benefited from the rise of the Chinese consumer and expanding global demand. More recently, slower Chinese growth, changing spending patterns, elevated savings rates, and a weaker real estate backdrop have reduced what was once a powerful source of growth. While many of these businesses continue to possess strong brands, attractive margins, and solid cash generation, their growth trajectories have become less compelling.

Enterprise software has faced a different challenge. For years, software companies represented the ideal combination of recurring revenue, high margins, strong cash flows, and attractive returns on capital. The emergence of generative AI has introduced uncertainty regarding the durability of traditional software business models and long-term growth assumptions. While many software companies remain high-quality businesses, investors have increasingly questioned whether future growth rates can match those achieved in the past.

Healthcare has also become a more challenging hunting ground for investors seeking businesses with the profitability, stability, and returns on capital traditionally associated with quality investing. Regulatory pressures, reimbursement concerns, and heightened policy scrutiny have weighed on growth expectations across portions of the sector.

While the underlying causes differ across sectors, the outcome has been remarkably similar. Businesses that once benefited from powerful structural growth drivers increasingly face slower growth, more uncertain demand, or heightened competitive pressures. Importantly, this does not mean these businesses are poor investments or that their quality characteristics have disappeared. Rather, it suggests that investors can no longer assume that the sources of growth that defined the previous decade will be the same sources of growth that define the next one.

The Quality Growth Dilemma

This highlights an important tension within quality growth investing.

Quality metrics are largely backward-looking. They measure what a company has achieved: historical profitability, historical returns on capital, earnings stability, and cash generation. Growth is inherently forward-looking. It reflects future demand, future market opportunities, future competitive positioning, and future earnings potential. During periods of stability, quality and growth often reinforce one another. During periods of significant technological or economic change, however, they can diverge.

This is particularly true when new growth opportunities emerge in industries that do not yet exhibit the characteristics traditionally associated with quality investing. Businesses investing heavily to build infrastructure, capture market share, or establish leadership in emerging technologies may appear less attractive on traditional quality measures even as their long-term growth prospects improve.

This is not a failure of quality investing. Rather, it is a reminder that quality and growth are not the same thing.

Conclusion

Quality remains an important component of successful investing. Businesses with strong competitive advantages, attractive returns on capital, and disciplined capital allocation should continue to create value over time.

However, quality alone is not growth. The characteristics that defined quality during the previous decade may not be the same characteristics that identify the next generation of growth leaders.

We believe growth remains the primary driver of long-term equity returns. Quality should support growth, not replace it. As markets evolve and new sources of growth emerge, investors must continually reassess where future growth resides rather than relying solely on the characteristics that defined success in the past.

Periods of paradigm change have historically created both risk and opportunity. Investors who remain anchored to the characteristics that defined the previous cycle may struggle to identify emerging leaders, while investors willing to look beyond traditional frameworks may discover new sources of growth before they become widely recognized.

The challenge is not abandoning quality. It is recognizing that the characteristics associated with future growth may evolve as the opportunity set evolves.

Many investors focus on identifying today's quality companies. We believe investors should focus on identifying tomorrow's quality companies.

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