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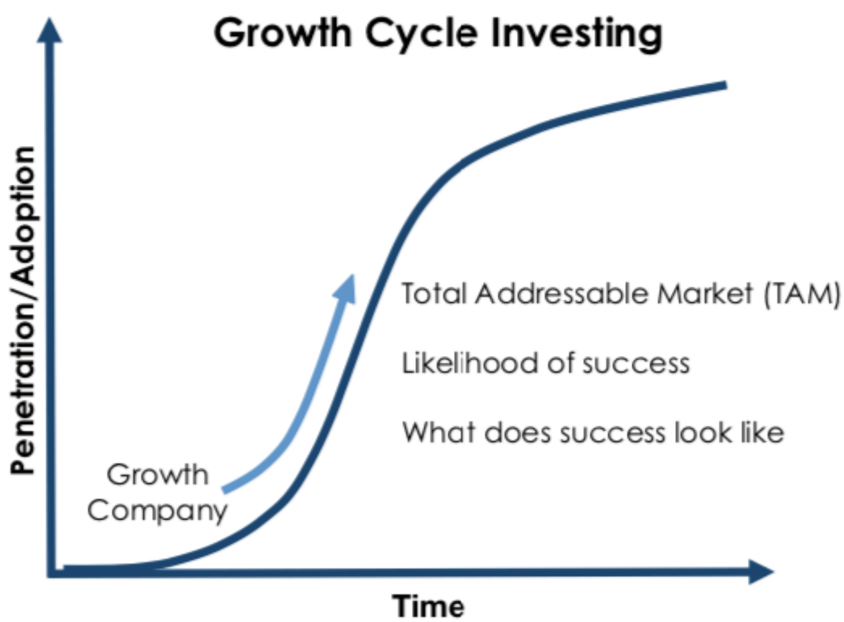
Growth Cycle Investing

July 2019

My co-founder Dave Walker and I were classmates at West Point and went on to serve as Army officers before beginning our financial careers. Something that stayed with me was the difference between strategy and tactics. In the military framework, strategy is how to win the war and tactics are how to win the battle. There is a similar dynamic in portfolio management; following a strategy that generates attractive returns still requires making appropriate tactical decisions along the way. Long-term success requires both. In the American Civil War, President Lincoln knew the Union had overwhelming military and economic advantages and designed a strategy to exploit that – fight the war on southern soil and attrite the Confederate army until they no longer had the means or will to fight. Unfortunately for Lincoln, it seemed all of the commanding generals he appointed slept through their tactics classes at West Point. The Confederate commanding general, Robert E. Lee, was a master tactician and decisively won battle after battle in the early years of the war. The Confederate strategy was to win the early battles and demoralize the Union populace and army, while lobbying to convince some European nations to recognize the Confederate States as an independent nation. The Confederacy had superb tactics, in fact it seemed invincible for a while, but its strategy was a long shot from the outset. By comparison, the Union had a winning strategy, but couldn't execute on tactics and almost lost the war. Eventually, Lincoln found Ulysses S. Grant and his tactical problems were solved, and the rest as they say, is history.



GrowthLine's investment strategy is built on what we call Growth Cycle Investing where we model companies moving along the adoption curve while focusing on three big questions: what is the total addressable market (the TAM), what is the likelihood this company will move up the curve and capture a meaningful portion of that TAM, and what does success look like if they get there? Our strategy is leading to attractive investment opportunities in this era of innovation driven disruptive change.

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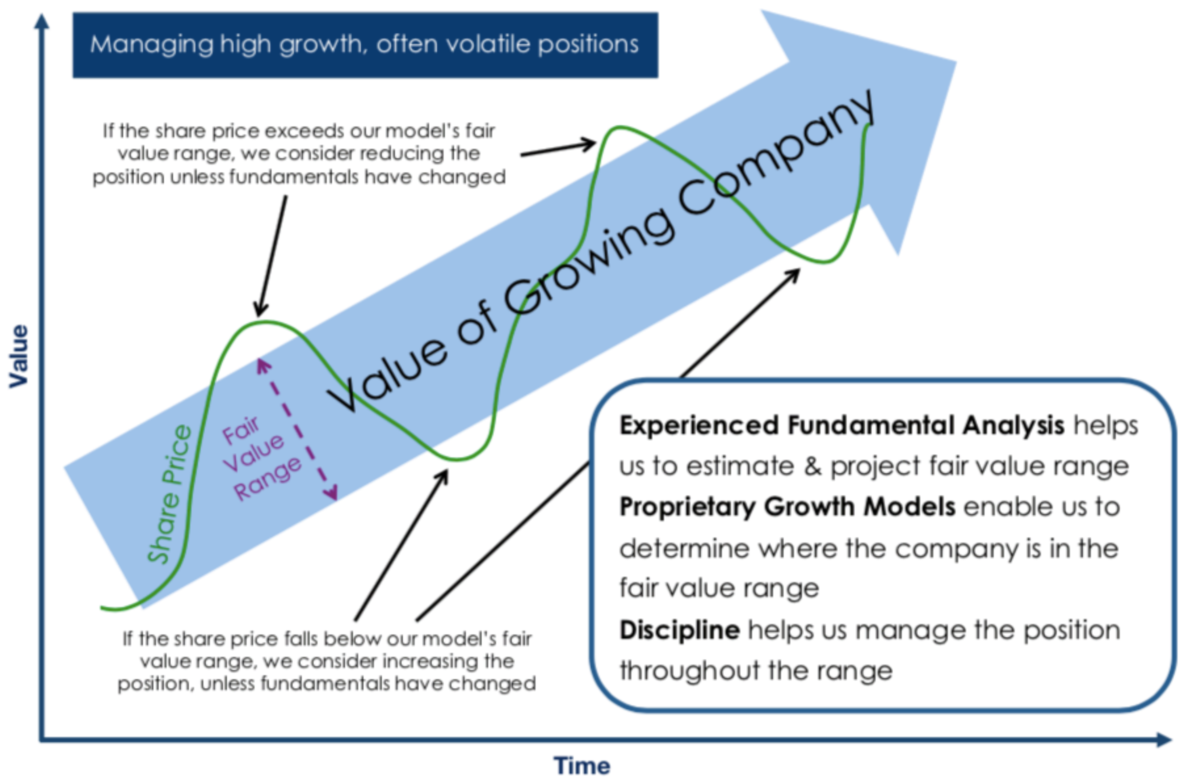
The tactics of Growth Cycle Investing guide our timing and position sizes. We model a company's progress as far into the future as we can with some degree of confidence, typically three to four years, and create a valuation range for the stock at that point. We then map that back to today, creating what

looks a big wide arrow generally moving up and to the right. This is the course the company's stock would take if it moved on a direct path reflecting the company's progress along the adoption curve. Where the stock trades today versus that range guides the timing of our buy and sell decisions.



This tactical framework is particularly useful with earlier stage growth companies that are often still losing money and trading at some multiple of forward revenue. In today's market we find quite of few examples in the software sector. The world's economy is in the early stage of what is called a *digital transformation* and those companies that are enablers of that transformation have significant opportunity for growth. Many of these fit our strategy, yet when we map them in our framework, most are trading well above our valuation ranges. We are generally avoiding these stocks for now, and in some cases, they provide short opportunities.

A similar phenomenon happened in 2014 with an earlier generation of software companies like Splunk and Workday. Splunk, for example, was growing rapidly as the company was a pioneer in big data analytics and its shares were priced to reflect its bright prospects, and then some. The stock hit a high of $106 in February of 2014 and despite the company posting superb results for the next four years, the stock languished between $40 and $70, only reaching a new high in May of 2018. There are quite a few 'Splunk-like' stocks trading in today's market, and while we aren't betting against most of these companies, the likelihood for meaningful gains in their shares appears challenging for now.

The GrowthLine Team
