Catching the Wave: Why Secular Growth Matters
August 16, 2019
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In our view, the specific market dynamics that influence a company's sales growth prospects have a greater impact on equity returns than the overall direction of the economy.

As the saying goes, a rising tide lifts all boats — when the economy is strong, stocks tend to perform well. Nonetheless, in both good times and bad, there is dispersion among equity returns, affirming the (obvious) truth that the health of the economy is only one of multiple factors influencing stock performance.

In our view, the most important driver of equity returns, particularly for emerging companies, is the growth rate of demand for their products and services. We believe that the best opportunities for market outperformance occur when a company is operating in a sector or industry that is undergoing a transformation, creating a growing wave of new customers. In our portfolio, we seek to invest in a select group of innovative companies that are able to capitalize on untapped, expanding markets.

Cyclical vs. Secular Growth

Broadly speaking, growth falls into two categories — cyclical and secular. Cyclical growth can be thought of as passive, whereas secular growth is driven by a structural change in a sector, industry or company.

Cyclical Growth

Cyclical growth, as the name implies, is highly correlated with the economic cycle. Industries that are driven by cyclical growth tend to deliver positive returns during expanding economies and do poorly during a downturn.

Automobiles are a great example. As you can see from the chart below, total vehicle sales plummeted during the Great Recession in 2008 and began recovering along with the general economy shortly thereafter.
Secular Growth

Secular growth occurs when something fundamentally changes within a sector or industry, creating a wave of new demand. Secular growth rates can be materially higher than cyclical growth rates, as secular growth depends on changes in customer behavior rather than changes to GDP.

One of the great secular growth stories of the 21st century has been the rise in e-commerce. Online sales have been taking progressively more market share from traditional retailers for the past 20 years, a secular trend that has literally transformed how people shop.
It is important to note that secular growth is not immune to hazards of a recession, although some trends are robust enough to withstand even the worst downturns. As you can see in the above chart, the market share of e-commerce dipped briefly during the great recession of 2008, but it resumed its steady climb shortly thereafter.

However, many secular trends are not as resilient. In fact, according to Morgan Stanley, only about 30% of growth companies are likely to repeat their success in back-to-back bull markets. In other words, more than two-thirds of secular growth trends slow down materially following a bear market, as the underlying demand drivers often change.

**Types of Secular Growth**

Secular growth can take many forms, and trends can differ across industries, but at the highest level we feel there are three primary types: (1) foundational technology; (2) replacement product, existing market; (3) new product, new market. And of course, individual companies sometimes fit into multiple categories.
Foundational Technology

Some technological innovations are so impactful that they not only generate their own wave of demand, but they also create a foundation upon which other businesses can grow. Importantly, companies at the epicenter of a foundational secular trend do not necessarily perform better or become larger than the firms that they eventually spawn.

The advent of the internet is a great example. Plenty of companies profited from the development of the internet infrastructure, but over time the biggest winners have been firms that successfully leveraged the technology, including Amazon, Google, Facebook, and Netflix.

Smartphones are another example, as the iOS and Android operating systems created an interconnected network of portable devices for businesses to exploit. Obviously, handset manufacturers like Apple and Samsung benefitted from the smartphone revolution, but so did companies like Uber and Lyft (among many others). In fact, despite its tepid IPO performance, Uber has nearly twice the market cap of Samsung.

And more recently, the rise of cloud computing has created a new foundation upon which many other businesses are emerging. It is among the most significant secular changes happening today, as software users around the world are beginning to appreciate the benefits of cloud deployments (faster implementation, automatic upgrades) versus the hassles of local installations. Software vendors like the shift also, as it allows them to move to a subscription business model, which creates smoother, more predictable revenue streams. Both cloud providers (e.g., Amazon Web Services and Microsoft Azure) as well as cloud-native software firms (e.g., Salesforce.com and Adobe) have benefitted tremendously from this secular trend, and it shows no sign of slowing down yet.

Replacement Product, Existing Market

Another major catalyst for secular growth occurs when an innovative startup builds a “better mousetrap,” taking market share from established incumbents. The key element to this type of growth is that the new company already knows that a viable market exists for its products/services. If they can truly deliver a superior solution, customers happily migrate, which results in outsized growth.

Amazon is an excellent example. As discussed above, online shopping has been taking market share from traditional retailers since it was introduced, and Amazon has been both the primary beneficiary as well as a major catalyst for the transition. The company has been able to expand continuously by capitalizing on consumer’s desire for convenience, and by creating a digital marketplace that obviated the need for in-person shopping. Features such as close-up photos, detailed product specifications, and crowdsourced reviews help Amazon customers feel comfortable purchasing items that they have never seen in person.

New Product, New Market

The third major type of secular growth occurs when an innovative startup develops a new product/service for a new market. In this case, the new offering must address a growing problem that
has been previously unsolved, creating naturally strong demand.

Google fits into this category nicely. Prior to the advent of the internet, there was no need for search engines. But once the web was born, search became indispensable, as people needed a tool to navigate the ever-expanding landscape. Initially there were multiple competitors in the space, but over time Google established its dominance, currently controlling over 92% of all search traffic globally. The chart below shows the steady increase in Google searches from 1999-2012.

Source: Internet Live Stats

It’s worth noting that Google also fits into the previous category (replacement product, existing market), as the site has effectively replaced traditional reference materials such as atlases, almanacs, and encyclopedias. But in our view, the specific category of secular growth is less important to the investment decision than the magnitude and staying power of the underlying trend(s).

**Secular Growth in Practice**

As emerging growth managers, we are constantly searching for companies that are well-positioned to take advantage of an untapped secular trend and deliver above market returns. The chart below provides a visual representation of our objective – to invest in companies just as they enter a period of
sustained revenue acceleration.

Below we have listed three companies from our portfolio that we feel have identified important secular growth trends and that we expect to deliver attractive returns over the near to medium term.

Twilio

Twilio is a cloud-based communications platform that enables companies to easily connect with customers over any channel. For example, Uber relies on Twilio’s communications infrastructure to connect drivers and passengers in real-time.

Twilio is the industry leader, disrupting a large, legacy communications market – Gartner estimates that $1.4 trillion is spent on communications, over four times the amount spent on enterprise software. Over time, we believe that a meaningful portion of the $1.4 trillion will migrate from hardware and network centered products to communication solutions integrated into software applications. As customer interactions become more virtualized, companies will have an increasing need to find ways to stay in touch – either for customer support or just to improve brand loyalty. Just as AWS (now at a $30 billion revenue run rate) has been massively disruptive for compute and storage, we see a similar opportunity for Twilio with communications.

Inspire

Inspire is a medical technology company that manufactures a treatment for people with moderate-to-severe Obstructive Sleep Apnea who are unable to use or get consistent benefit from traditional CPAP machines. We believe this is a classic emerging secular growth opportunity, as the company is already the leader in its space but it has only achieved limited penetration thus far. The company received
25,000 inquiries about the treatment in 2018 (a 30% increase from the prior year) but only completed 2,000 procedures. As people get more comfortable with the treatment and more doctors become familiar with the implant process, we expect its adoption rate will accelerate, particularly as health insurance companies make it easier to reimburse patients.

**Avalara**

Avalara is a software company that allows vendors to more efficiently address a very boring and traditional problem – sales tax. We’ve written about this firm previously, but we think it’s worth revisiting because the company is simultaneously leveraging two important secular growth trends. First, it is capitalizing on increasingly complicated sales tax landscape, which is expected to get more complex since the Supreme Court ruled last year in the Wayfair decision that a physical presence was no longer required for a state to be able to collect sales tax. Following the decision, several large states (California, Texas, New York) have begun to shift the standard to laws requiring remote sellers to collect and remit sales tax.

Additionally, Avalara is a cloud-based application, which reduces its IT overhead and should steepen the adoption curve. The company is a leader in its space, and barring the entry of newer, tougher competitors we feel they are very well positioned to continue their rapid growth.

**What’s Next?**

In our view, identifying secular growth trends is the key to generating sustainable above market equity returns. We are always monitoring market developments for new trends, with topics such as artificial intelligence, the internet of things, and big data currently on our radar.

1 - Dennis Sherva, Morgan Stanley, “Investing in Emerging Growth Stocks,” April, 1987

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