

THE QUALITY PULSE

ONE INSIGHT. ONE PERSPECTIVE. EVERY WEEK.

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6 MIN READ

Growth is easy. Returns are hard.



Why the quality of growth matters more than growth itself

Growth is seductive. For investors, it offers a simple story: more customers, more revenues, more earnings, a larger addressable market. But an owner should begin somewhere else: imagine you owned the entire company. What would you do with the next dollar of cash it generates? Almost any company can grow if it is willing to spend enough money – another factory, another store, a competitor, more salespeople, another data centre, another billion in research. Revenue will often follow.

The harder question is what happens to the money required to create that growth. For an owner, growth is not the objective. The objective is to deploy scarce capital today in a way that creates substantially more value tomorrow. Growth is the consequence; capital allocation is the decision. Economic value is created only when the return on incremental capital exceeds its cost. That distinction is easy to miss because growth is visible immediately in the income statement, while its true cost is distributed across capital expenditure, acquisitions, working capital, R&D and future commitments. Two companies growing at exactly the same rate can therefore create radically different amounts of value.



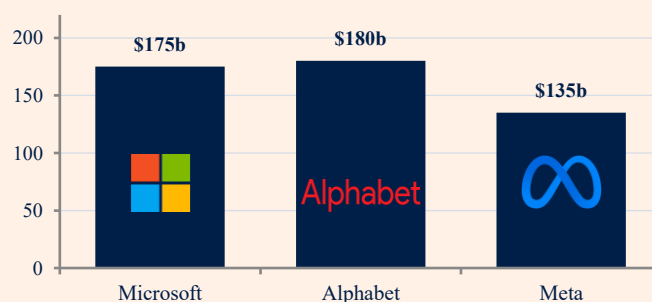
ROIC > cost of capital → value creation

ROIC < cost of capital → value destruction

THE PRICE OF GROWTH

The current AI investment cycle makes the distinction unusually visible. The leaders of the largest technology companies are effectively making some of the biggest capital-allocation decisions in corporate history. Microsoft expects roughly \$175b of calendar-year 2026 capital expenditure; Alphabet guides to \$175–185b; Meta to \$125–145b.[1] Every new data centre commits capital today against assumptions about demand, utilisation, pricing, energy availability and technological life years into the future. The technology may ultimately justify every dollar. But it has to. Invest too much and returns may collapse; invest too little and strategic relevance may be lost.

Expected 2026 capital expenditure (\$bn): Alphabet and Meta shown at the midpoint of disclosed guidance.



SOURCE: COMPANY DISCLOSURES [1]



INVESTMENT TAKEAWAY

Growth is the consequence; capital allocation is the decision. Value is created only where the return on incremental capital exceeds its cost – not where revenue grows fastest.

FROM DEBT TO REINVESTMENT

Our previous Quality Pulse looked at corporate debt and the way decisions made yesterday can restrict a company's strategic freedom tomorrow. Investment is the forward-looking side of the same problem: management gives up flexibility today in exchange for an expected stream of cash flows tomorrow. The more capital a company commits, the more important the assumptions behind those cash flows become. Factories, acquisitions, inventory, data centres and R&D are economically different investments – yet the decision is the same: give up a dollar today in the expectation of receiving substantially more tomorrow.

THE REINVESTMENT PROBLEM

Consider two companies that each generate \$1b of free cash flow. Company A has few attractive opportunities to reinvest. Company B can repeatedly deploy a meaningful share of that cash into projects capable of producing high returns for many years. Today both may look equally profitable. Over a decade, they can become radically different investments. The difference is reinvestment runway: a great business needs more than a high historical return on capital – it needs opportunities to deploy additional capital at attractive incremental returns.



Can \$1 become \$1.20 ... \$1.50 ... \$2.00?

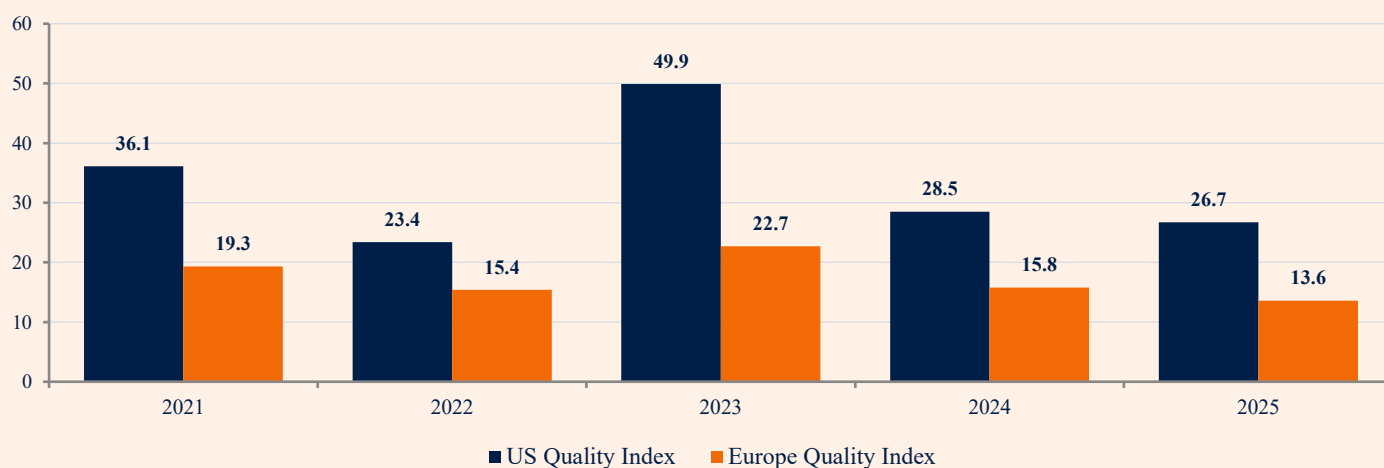
The ability to answer "yes" repeatedly is the foundation of compounding.

Quality is not growth. It is profitable reinvestment sustained over time – knowing where the flywheel can be pushed harder, and knowing where to stop.

HOW TO ASSESS VALUE CREATION

The ROIC–WACC spread provides the clearest test because it captures both sides of the capital-allocation decision in a single measure: ROIC (return on invested capital) captures the return a company earns on the capital employed in the business. WACC (weighted average cost of capital) is the return required by the providers of debt and equity for bearing that risk. A positive spread means each dollar of invested capital is earning more than its opportunity cost; the size and persistence of that spread show how much value the business is creating and whether that advantage is enduring. Today's US and European Quality companies generated positive aggregate spreads in every year shown – a strong foundation for long-term compounding.[2]

Current Quality companies: ROIC–WACC spread in percentage points, 2021–2025.

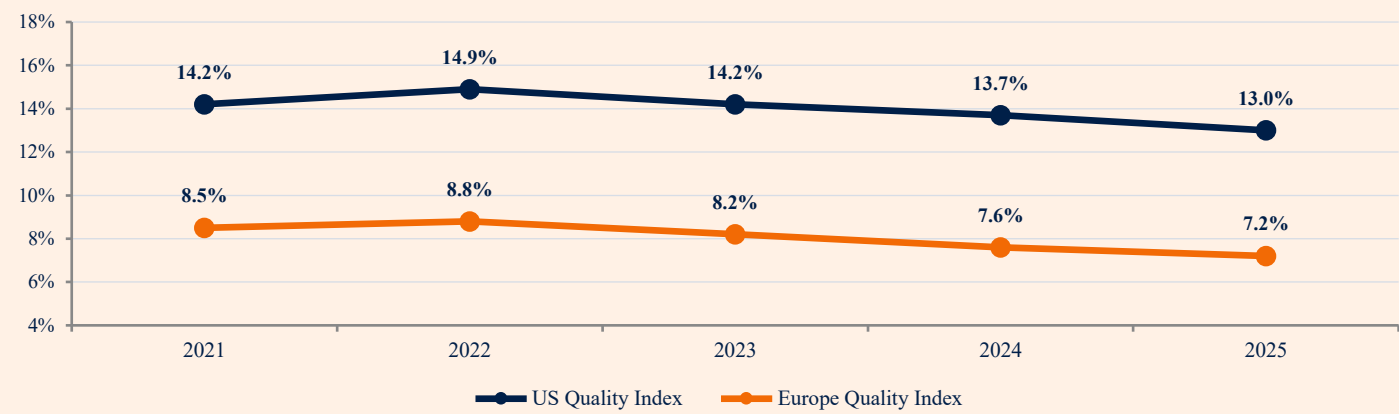


SOURCE: HQAM, REFINITIV [2]

R&D REMAINED HEALTHY

Crucially, those returns have not come from starving the future. R&D remained a healthy share of sales across both groups from 2021 to 2025 – companies continued to invest in organic growth while preserving returns above their cost of capital. That combination of current value creation and continued reinvestment gives the compounding runway economic substance.[2]

R&D investment as % of sales, 2021–2025.



SOURCE: HQAM, REFINITIV [2]

VERTEX: FROM CASH FLOW TO OPTIONALITY

Vertex Pharmaceuticals offers an unusually clean illustration of the owner's problem. Its cystic-fibrosis franchise became an exceptional cash engine. That created a luxury problem every great business eventually faces: what should management do when the original franchise produces more capital than it needs? Return it, acquire unrelated growth, or reinvest behind capabilities where the company has a genuine right to win? Vertex chose the latter path: it is extending its CF franchise while investing in sickle cell disease and beta thalassemia, acute pain, kidney disease and other therapeutic areas. Pharmaceutical R&D is inherently uncertain. The demanding question is therefore whether Vertex can convert its cash flows and scientific capabilities into new products that earn attractive returns.[3]

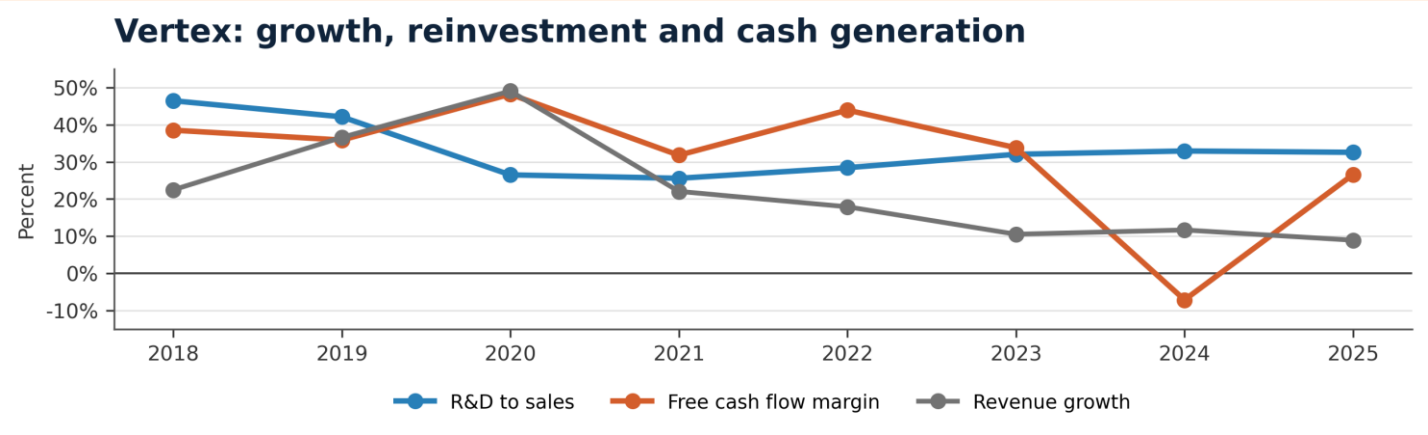


\$12.0b Revenue 2025, up 9% SOURCE: VERTEX [3]	27.8% Annual revenue growth, 2015–2025 SOURCE: VERTEX [3]	32.6% R&D as a share of sales, 2025 SOURCE: VERTEX [3]	\$3.2b Free cash flow 2025, 26.6% of revenue SOURCE: VERTEX [3]
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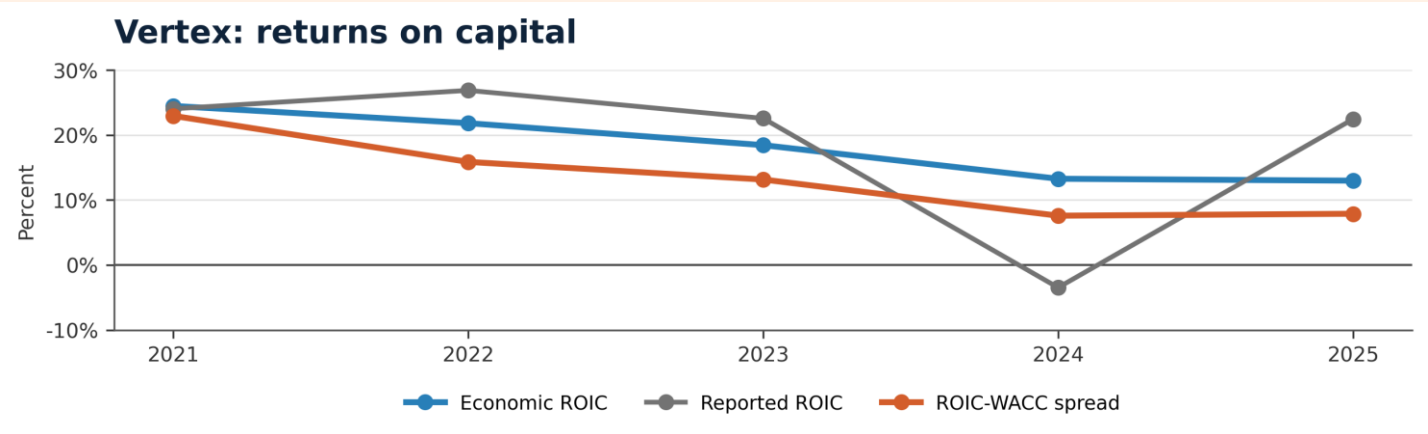
WHAT THE NUMBERS SAY

The longer history shows Vertex's transition from product-led growth to capital-allocation-led value creation. As the CF franchise matured, growth slowed to 8.9% in 2025, but R&D still represented 32.6% of sales. Free cash flow recovered to \$3.2b after the 2024 loss associated largely with the approximately \$5b Alpine acquisition. There are early signs that the flywheel is broadening: in Q2 2026, revenue rose 12% to \$3.33b and full-year guidance was raised to \$13.1–13.2b. CASGEVY has created a commercial presence in sickle cell disease and beta thalassemia; JOURNAVX has taken Vertex into acute pain.[3] These developments indicate new sources of growth – they do not establish that the growth is creating value. On the R&D-capitalised basis, 2025 economic ROIC was 13.0%, a 7.9 percentage-point spread over WACC.[4] That supports the thesis that Vertex continues to create value while funding its next generation of products.

Vertex: growth, reinvestment and cash generation



Vertex: returns on capital



SOURCE: VERTEX ROIC RESEARCH MODEL (HQAM, LSEG) [4]

THE COMPOUNDING FLYWHEEL



What matters is not that Vertex is expanding into new therapeutic areas, but how successfully it can deploy capital there. If it can carry its existing scientific capabilities into new products while earning attractive returns on capital, today's cash flow can translate into additional enterprise value over the long term.

BUT R&D IS CAPITAL TOO

When investors think about capital intensity, they think of factories, machinery or AI data centres. A pharmaceutical company looks completely different. Economically, however, R&D is also an investment: cash is spent today in pursuit of cash flows many years into the future. The assets could hardly be more different from a data centre – the capital-allocation question is identical: what future cash flow will today's investment generate?

FIVE QUESTIONS FOR QUALITY INVESTORS

1	CAPITAL REQUIRED	How much capital does the growth require? Revenue growth without understanding the investment behind it tells us little.
2	INCREMENTAL RETURN	What return can that incremental capital earn? Historical ROIC describes yesterday's economics; incremental returns determine tomorrow's.
3	DURABILITY	How long can those returns remain attractive? Durable competitive advantage determines how long the reinvestment runway remains valuable.
4	REINVESTMENT CAPACITY	How much can the company reinvest? A spectacular return on a tiny amount of capital may matter less than a strong return applied repeatedly to a large opportunity.
5	MARGIN FOR ERROR	What happens if management is wrong? Balance-sheet strength matters because uncertain investments sometimes fail.

THE PULSE



Imagine owning the entire business. Every year, cash arrives on your desk. You can return it to shareholders, repay debt, acquire another business or reinvest it. The easiest way to make the company bigger is to spend it.

The difficult part is finding opportunities where a dollar invested today can become substantially more than a dollar tomorrow – and doing so repeatedly without weakening the business.

The best management teams are capital allocators. The best Quality companies continually give them attractive places to put the next dollar. Growth is easy. Returns are hard. Compounding requires both.

SOURCES

1. Microsoft (2026), FY2026 Q4 earnings call; Alphabet (2026), Q4 2025 earnings call; Meta (2026), Q1 2026 results – capex guidance, ranges shown at midpoints
2. HQAM, Refinitiv – aggregate ROIC–WACC spreads and R&D intensity of the US and Europe Quality indices, 2021–2025
3. Vertex Pharmaceuticals (2026), FY2025 results and Q2 2026 financial results – pipeline outcomes remain subject to clinical and regulatory risk
4. HQAM (2026), Vertex ROIC research model using company filings and LSEG data; R&D capitalised
5. McKinsey, “Balancing ROIC and growth to build value”; BIS research on the AI investment race – conceptual framework
6. Collins, J., Good to Great – flywheel and disciplined-focus framing



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