MUTUAL FUNDS WORKSHOP

Aggressive Growth Stock Funds: Examining a Rocket's Blueprints

By John Markese

Before you decide to take a ride on a rocket, it is wise to familiarize yourself with the basics of the propulsion system.

Aggressive growth funds are the rockets of the domestic stock mutual funds. While they currently are in orbit and may suffer some heat damage as they reenter the atmosphere, there will be many opportunities for future launches. A look at the blueprints can reveal much about the likely trajectory.

Aggressive growth funds share some common characteristics. These funds are definitely carefully aimed, concentrating in a few industries and often in a handful of companies. Both of these strategies are likely to be volatile. With an investment objective of maximum capital gains, stocks are held that have potential rapid earnings growth and share prices that follow. Since these stocks are not dividend producers, yield is not available to dampen return volatility. Most also are focused in the small stock end of the market, although as aggressive funds grow, taking in more money under management, they tend to evolve into mid-capitalization and large-capitalization stock funds. Small stocks have proven to be over half again as volatile in total return as large established firms.

These funds also tend to remain fully invested—they do not engage in market timing or hold defensive cash positions. Large cash balances—above 10% of the portfolio—are more likely to indicate new and large cash flows into the fund that the portfolio manager is unable to quickly employ. Because of the high returns these funds occasionally generate and the attendant media coverage, new money chases aggressive funds just after they have posted substantial gains, when promising opportunities may be scarce.

Tax Behavior

Even though these funds stress capital gains and throw off virtually no income, some are tax dreams and others are tax nightmares. Capital gains distributions can be large and frequent, particularly for funds that trade aggressively, moving among industries and stocks. Using effective tax tactics, some funds carefully offset realized gains with realized losses to the extent possible; other funds, though, seem oblivious to investor tax consequences of their portfolio decisions. And while some funds have built up substantial unrealized gains as a percentage of net asset value, one of the best indicators of probable tax behavior is the long-term, year-by-year, history of distributions made by the fund over different market circumstances, unless there is a portfolio manager change and an investment philosophy change, as well.

Figure 1 illustrates the very different approaches to distributions and tax consequences for investors of two top-performing aggressive growth funds. Twentieth Century Ultra is managed very tax efficiently, as the year-by-year distribution record indicates. The market correction in 1987 forced many funds to sell stocks to meet redemptions, mandating distributions of net realized gains. The PBHG Growth fund has made large periodic capital gains distributions beyond just the experience of 1987. As expected, both funds have insignificant income distributions. The fact that Twentieth Century Ultra has 19% of the portfolio as unrealized gains, versus a 1% net unrealized loss in the PBHG portfolio, is probably less important than the distribution record.

The ideal aggressive fund from a tax standpoint is one that never makes a distribution. Funds that are top performers but have a history of large capital gains distributions are candidates for tax-sheltered investments, such as IRAs and 401(k) plans, although all money withdrawn at retirement is taxed at ordinary income tax rates.

Fund Characteristics

Table 1 lists the top 10 non-sector aggressive growth funds by total return for the last 12 months (ending Sept. 30, 1995), along with fund portfolio statistics. At the bottom of the

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Figure 1.
How Two Funds Handle Distributions

Twentieth Century Ultra

PER SHARE DATA

	1994	1993	1992	1991	1990	1989	1988	1987	1986	1985
Dividends, Net Income ($)	0.65	0.00	0.00	0.00	0.00	0.20	0.00	0.01	0.01	0.00
Distrib'ns, Cap Gain ($)	0.00	0.00	0.00	0.00	0.03	0.95	0.00	3.26	0.00	0.00
Net Asset Value ($)	19.95	21.39	17.56	17.34	9.30	8.53	7.06	6.23	8.92	8.10
Expense Ratio (%)	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.01	1.01
Net Income to Assets (%)	-0.10	-0.60	-0.40	-0.50	-0.30	2.21	-0.30	-0.50	na	0.10
Portfolio Turnover (%)	78	53	59	42	141	132	140	137	99	100
Total Assets (Millions $)	9,850	8,353	4,275	2,148	330	347	259	236	314	385

Unrealized Net Capital Gains or Losses: 19% of portfolio value

PBHG Growth

PER SHARE DATA

	1994	1993	1992	1991	1990	1989	1988	1987	1986	1985
Dividends, Net Income ($)	0.00	0.00	0.00	0.00	0.00	0.04	0.00	0.00	0.07	–
Distrib'ns, Cap Gain ($)	0.01	0.19	2.45	2.43	0.79	2.81	0.03	4.24	0.00	–
Net Asset Value ($)	15.91	15.20	10.51	10.53	8.74	10.71	10.51	9.86	12.32	–
Expense Ratio (%)	1.55	2.39	1.52	1.50	1.32	1.19	1.21	1.31	1.52	–
Net Income to Assets (%)	-0.78	-1.69	-0.55	-0.09	-0.35	0.20	0.02	0.36	0.82	–
Portfolio Turnover (%)	94	209	114	228	219	175	208	213	97	–
Total Assets (Millions $)	745	121	7	10	18	23	28	30	15	–

Unrealized Net Capital Gains or Losses: -1% of portfolio value

Source: "The Individual Investor's Guide to Low-Load Mutual Funds," 14th edition, American Association of Individual Investors.

group are two sector funds concentrating in computers and technology, which are shown for comparison purposes, since so many of these aggressive growth funds are heavily invested in these fields.

These statistics, of course, are not a complete blueprint for each fund; a prospectus that defines investment objective and strategy and an annual report that details the fund's holdings individually by sector or industry provides a more complete view. However, the statistics do provide a useful, quick summary of what fuels these funds.

The percentage held in cash by these funds is low, with only one fund just above 10%—they are effectively fully invested, except for small amounts of cash that reflect cash inflows and transactions rather than defensive, market timing positions. The largest four portfolio sector holdings are given as a percentage of the portfolio value to indicate the level of diversification or concentration of these funds. First, it is clear that computer software and services, electrical and electronic components, semiconductors, and communications sectors predominate among these aggressive funds; second, these are highly related sectors; and, third, for most of these funds, investments in just four sectors total 40%, 50% or even 60% of their portfolio, hardly well-diversified. Looking at the top four stock holdings for each fund is another way to view concentration, and the percentage that these stocks make up of the total portfolio ranges from 6.7% to a very high 19.6%. While only a few stocks appear among the top four for more than one fund, many of these stocks are close competitors within the same industries.

The number of securities held by the funds is a crude gauge of concentration. While much less than 100 stocks would be sufficient for diversification if they were in lines of business that were not highly related, the numbers for these aggressive funds probably only indicate that the risks of individual firms are minimized; because many are in lines of business that are related, industry risk factors remain. However, the arithmetic is hard to overlook: A fund with substantial money under management and few securities equals high percentages of the fund's assets in each stock. Twentieth Century Vista, with $1.5 billion in assets and only 70 securities, has almost 20% of the fund invested in the top four stocks.

Portfolio turnover, the lower of purchases or sales as a percentage of average portfolio value, is a rough indicator of trading activity by the fund, and the stock fund average turnover is about 100% per year. Most of these funds fall near the average, and a few are even below, but one fund—Bull & Bear Special Equities at 309%—is considerably above

Table 1.
The Top 10 Aggressive Growth Funds: Portfolio Statistics

Name	Cash (%)	Largest Holdings in Portfolio	Top 4 Stocks	No. of Stocks	Port. Turnover (recent ann'l) (%)	Exp. Ratio (recent ann'l) (%)	Yield (as of 9/30/95) (%)	Annual Return (as of 9/30/95) 1-Yr (%)	3-Yr (%)	5-Yr (%)	Total Risk Rank
Twentieth Century Vista*	5	electr & electronic compon 23.1%, industrial equip & mach'ry 17.3%, communications equipment 13.4%, computer software & serv 9.7% Total: 63.5%	LSI Logic Corp. 6.2%, Tellabs, Inc. 5.2%, KLA Instruments 4.9%, Atmel Corp. 3.1% Total: 19.4%	70	111	1.00	0	54.3	23.4	24.7	High
Twentieth Century Giftrust*	3	computer software & serv 17.4%, industrial equip & mach'ry 17.2%, electr & electronic compon 13.2%, computer peripherals 13.0% Total: 60.8%	Tencor Instruments 4.5%, Ultratech Stepper 3.5%, Security Dynamics Tech 2.8%, Community Health Sys 2.6% Total: 13.4%	71	115	1.00	0	49.5	40.1	38.2	High
Scudder Development*	1	computer software 13.2%, medical supply 8.7%, commercial services 6.1%, telecommun equip 6.1% Total: 34.1%	Informix Corp 3.4%, American Power Conver 3.4%, Parametric Technology 3.2%, Atmel Corp. 2.9% Total: 12.9%	118	41	1.32	0	48.4	20.1	23.9	High
T Rowe Price New Horizons*	6	computer software & serv 18.1%, semiconductors 7.8%, health care services 6.5%, business services 5.7% Total: 38.1%	Paychex 3.4%, CUC International 3.2%, Viacom 2.9%, Maxim Integrated Prod 1.8% Total: 11.3%	259	44	0.93	0	47.0	28.7	27.8	High
Bull & Bear Special Equities	0	computer software & serv 18.7%, radio & TV equipment 10.5%, telephone & telegraph 10.1%, personal credit institutions 7.5% Total: 46.8%	AmeriCredit Corp. 7.5%, New World Communs 4.5%, Globalink Inc. 4.4%, VMARK Software 3.2% Total: 19.6%	39	309	2.92	0	46.9	21.9	18.2	High
USAA Aggressive Growth*	5	computer software & serv 15.2%, communication equip 10.3%, specialty retail 9.9%, healthcare 9.5% Total: 44.9%	Charles Schwab 1.8%, Amgen 1.8%, St. John Knits 1.7%, HBO 1.4% Total: 6.7%	195	138	0.86	0	46.2	21.5	22.5	High
PBHG Growth*	11	software 11.2%, specialty retail 7.0%, semiconductor equipment 6.2%, long-term patient care 4.8% Total: 29.2%	Coventry 2.2%, Alliance Semicond 1.9%, U.S. Robotics 1.7%, PhyCor 1.6% Total: 7.4%	90	118	1.50	0	44.1	44.6	35.8	High
Twentieth Century Ultra	5	computer software & serv 18.7%, electr & electronic compon 13.5%, computer peripherals 11.1%, computer systems 10.0% Total: 53.3%	IBM 4.6%, Oracle Systems 4.0%, Microsoft Corp. 3.7%, Intel Corp. 3.5% Total: 15.8%	159	78	1.00	0	41.7	24.8	29.3	High
Warburg Pincus Emerging Growth*	9	computers 13.3%, healthcare 12.1%, electronics 10.8%, business services 9.0% Total: 45.2%	Synopsys, Inc. 2.6%, Maxim Integrated Prod 2.6%, Platinum Technology 2.1%, Healthcare Compare 1.9% Total: 9.2%	81	60	1.22	0	41.5	23.9	25.1	High

Table 1.
continued

Name	Cash (%)	Largest Holdings in Portfolio	Top 4 Stocks	No. of Stocks	Port. Turnover (recent ann'l) (%)	Exp. Ratio (recent ann'l) (%)	Yield (as of 9/30/95) (%)	Annual Return (as of 9/30/95) 1-Yr (%)	3-Yr (%)	5-Yr (%)	Total Risk Rank
Oberweis Emerging Growth*	2	computer periph 11.0%, computer software 10.4%, electronics 8.4%, telecommunications 7.8% Total: 37.6%	ValuJet Airlines 4.9%, U.S. Robotics Corp. 3.6%, Lone Star Steakhouse 2.5%, Madge N.V. 2.3% Total: 13.3%	149	66	1.78	0	41.0	21.8	29.7	High
Sample Sector Funds: A Comparison											
Fidelity Select Computers	11	semiconductors 29.5%, computers 9.4%, electronic equip 6.2%, computer software 4.2% Total: 49.3%	Micron Technology 9.0%, Compaq Computer 5.0%, Nippon Steel Semicond 3.8%, SGS-Thomson Microelectr 2.5% Total: 20.3%	157	189	1.69	0	80.6	48.3	39.7	High
Fidelity Select Technology	15	semiconductors 20.8%, computers 8.0%, computer software 5.5%, datacommun equip 5.5% Total: 39.8%	Micron Technology 8.7%, Compaq Computer 4.3%, Cisco Systems 3.4%, IBM 2.9% Total: 19.3%	205	102	1.56	0	62.2	37.3	37.1	High

**Small stock fund.*

average. A 200% turnover, twice the value of the portfolio traded in a year, is high, and 300% is in the stratosphere. Unless realized capital gains can be offset by realized capital losses, high turnover translates to high distributions, not to mention added brokerage costs that reduce returns dollar for dollar.

The expense ratio, the costs of running the fund plus any 12b-1 charge for distribution and sales costs (but not loads, fees or brokerage costs) divided by average net assets of the fund, is worth a look because a high ratio is hard to overcome year after year; to do so requires consistently brilliant management or simply taking higher risks. The expense ratio is reflected in return calculations and if any category can withstand a higher expense ratio, it is the aggressive growth category; your money market fund, in contrast, cannot. With an average expense ratio for aggressive funds of 1.5%, anything above 2.0% is high, which puts the Bull & Bear Special Equities fund at a long-run disadvantage, with an expense ratio of 2.92%. While probably not noticeable in the short term, particularly when markets are on a bull run, it can be a noticeable drag on performance as the years go by.

Yield—income distributions to average net assets—is, as expected for the aggressive class, zero. Stocks that have the potential for rapid earnings growth and are often small emerging firms, sometimes in emerging industries, rarely pay dividends because of their high returns on reinvestment of earnings. Yield helps to dampen return volatility and for these aggressive growth funds there is no income stabilizer.

The returns on these funds can be seductive, 50% in a year, and 20% or even 30% a year for five years. But these are the top funds that managed to be positioned in the right stocks and industries. The bottom of the list of aggressive funds is not quite as spectacular, but the last five years was the best of times for the category. And don't forget the risk. Overall, all of these funds are the most volatile of all funds, earning the high-risk label. They will rise the most in a bull market and plummet back to earth the fastest in a bear market.

For the most part, these aggressive growth funds are a bundle of two or three high-risk sector funds. They provide the individual investor who is unsure of precisely what sector will be hot next with an easier choice and some added diversification over a single sector fund. It is all too easy to look at the two sector funds at the bottom of the list, computers and technology, and ask why not just jump on a sector fund? But what's on top now is unlikely to be on top next time around, and hiring an aggressive fund manager to make sector choices has some appeal.

A well-diversified portfolio should have some funds invested in high growth stocks, particularly small emerging stocks. Just remember these funds are the rockets of the industry and before you sign on for a ride, make sure you read the specs.