

# A BASIC APPROACH TO GROWTH WITH A FOCUS ON THE MID-CAPS

## FUND FACTS

### U.S. GLOBAL ACCOLADE: BONNEL GROWTH FUND— ACBGX

#### CATEGORY:

Aggressive Growth

#### PERFORMANCE: (thru 12/31/99)

	Fund	Category
Compound Annual Return (%)		
1 Year	81.4	47.7
3 Years	36.5	23.1
5 Years	36.4	23.5

#### RISK: (relative to category)

Above Average

#### TOTAL ASSETS: (as of 2/28/00)

\$400 million

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*Sometimes, a fund picks technology. And sometimes, technology picks the fund. Sector funds pick technology because that's where they want to focus their efforts. Aggressive growth funds, on the other hand, can end up weighted toward technology because that's where the growth is.*

*Either way, there is no denying the recent results—extraordinarily high rates of return for the past few years.*

*One non-sector fund that has benefited from the tech-stock explosion in particular and the boom in growth stocks in general is the Bonnel Growth Fund, part of the U.S. Global Accolade group of funds. The fund, which focuses on mid-cap growth stocks, has been among the top 20% of aggressive growth funds for one-, three- and five-year periods (as of year-end 1999). Currently, it has about \$400 million in total assets.*

*In early March, portfolio manager Arthur Bonnel discussed the management of the fund with Maria Crawford Scott.*

#### **What's the main investment philosophy that you use in managing the fund?**

We are a fund that focuses on long-term growth. We cover about 10,000 different companies and we look at four basic things.

One, earnings have to be going up, and it doesn't matter if they're going up 2% or 102%, we want them up from last year. We're looking for earnings growth. We're not looking to bottom fish or any of that kind of thing. And we are looking for growth quarter over quarter—in other words, we look at comparable quarters in each year. If we find that earnings are dropping, we avoid them. So that's the first step and it's pretty simple.

Second, we look at the current ratio, which is current assets versus current liabilities. We like companies with current ratios of 2-to-1 or better. We want the company to have enough cash on hand to continue to do research and development, pay the salaries, insurance, light bills, etc.

It is interesting because not many investors look at that ratio, even though it's very simple. But periodically it really pays off. For instance, last year Rite-Aid (RAD) had some major problems. We had been following them but saw deterioration in their current ratio some time before those problems developed—they had been at 2-to-1 but it had dropped to 1-to-1.

And just recently, Procter & Gamble (PG) said they were going to have problems. Now, if you look at their report as of the end of September, their current ratio went below 1-to-1, compared to the prior year when it was above 1-to-1. Of course, their main problems may be elsewhere, but the current ratio says that they may be having cash flow problems, and we keep an eye on it. I consider it very, very important.

The third thing we look at is the amount of debt to equity. Here, the less debt the better, but we do compare stocks to their industry group averages. Basically, though, if I can find a company that has no debt, I'm a happy camper. One of the companies that has done extremely well for us this year is Adobe Systems (ADBE). That company has absolutely no debt. Intel (INTC) and Microsoft (MSFT) are also companies with little or no debt.

We generally don't like to see much more than 30% debt to equity. Most of the companies in today's environment, the technology arena, have less than 5%, and a lot of them have absolutely no debt. Other things being equal, I will pick the company that has less debt. And that's part of the reason why the Nasdaq companies have been doing well this year versus the Dow. The Federal Reserve keeps increasing interest rates, and the big board

[New York Stock Exchange-listed] stocks have a lot of debt, so they are hit more when interest rates rise.

The last item we look at is management ownership. We like companies in which management holds equity of between 5% and 20%. If you get much higher than that, you tend to get family-run businesses, and they tend not to move with much alacrity; the shareholders' interests aren't number one. I want a company in which management has a meaningful stake, but it is not family-controlled.

Those are the four things that we focus on. There are many other things we look at secondarily—the actual cash flow, the technical patterns of the stock. We're not technicians, but I don't buy a stock that has been dropping in price for the past two or three years because then you have a lot of overhead supply.

***Of the 10,000 companies you screen, how many do your criteria typically turn up?***

We probably come up with between 400 and 600 a quarter. Of those, the fund will hold around 100. Of course, we have secondary criteria, as well. But basically, of those 400 stocks, we only want to own a certain number in each area. For instance, I'll look at the list and say, I have enough semiconductors or I have enough home builders. So that's another screening criteria. I do that deliberately because I don't want to be too heavily weighted in any area. Right now, we have a lot of the fund in semiconductors and software, and technology in general. But we've grown into that, and I'm kind of in a bind there. I didn't buy the percentage that it shows. My shareholders are lucky to have had it grown to that figure.

***Do you have any size criteria?***

We focus on the mid-cap stocks, although that's been kind of difficult lately, similar to the problem I mentioned earlier. We bought a few stocks, like Adobe, when it was in the teens, and now it's a \$12 billion company at about \$100 a share, so I suddenly have a large-cap stock even though I bought it when it was a mid-cap. I've got another company, Qlogic (QLGC), that I paid \$5 a share for and it's a \$180 stock now. Of course, this is a great problem to have, and I hope I have this problem next year. But we focus on buying mid-cap stocks.

***You mentioned earnings growth as one criterion. If there were two companies that met most of the requirements, would you go for the one with the higher earnings growth?***

Not necessarily. As an example, about two years ago, Intel came through with an earnings increase of only about 2%, and prior to that they had been having relatively flat earnings for a year and a half. Basically, the semiconductor industry was having some problems. But I bought it, and I made 70% to 80% in about six

months. At the same time, there were other companies that were crossing my desk with earnings increases of 50% or 100%.

I am very disciplined. If earnings are going down I don't buy. If the current ratio is deteriorating, I don't buy. If the debt's increasing, and it's above the industry average, I don't buy. I'm extremely strict about those requirements. But then, there's a judgment call. Why did I buy Intel? It looked to me like the industry was probably done with its problems, and within the industry, Intel is a leading manufacturer, very innovative. It had that whiff of a potential real winner—it was a quality company that had been having a rough time for awhile. All of a sudden some good numbers came out—they got a little more cash, they paid off some of their debt, management had been buying a little bit of stock. So, even with a small amount of earnings increase, they could take off.

***The portfolio that you've had within the past year or two has been very heavily weighted toward technology. Part of that, as you mentioned, is simply because those stocks have grown so quickly relative to others. Nonetheless, you do seem to favor those types of stocks. Is that a result of your basically bottom-up approach?***

Yes, although I'm also extremely enthusiastic and optimistic about the state of the economy. I don't consider the fund a technology fund, I consider myself buying industries that are part of the new economy. Actually, it isn't really a new era, it's just the evolution of commerce and business that we've entered into, and I'm going with it. I'm buying growth companies.

***What about some of the old-line economy stocks? Do you feel that those are not real growth stocks anymore?***

They're value stocks. I do believe that they're going to have a time period, probably sooner rather than later, when they're going to come to the forefront. Technology stocks will pause, and when there's that pause, money will shift into value. There's nothing wrong with a lot of those companies. But, taking again the example of Procter & Gamble, its earnings growth was around 8% and it was selling at around 40 times earnings. I don't mind buying a company where earnings are growing at 50% or 100% and selling at maybe a price-earnings ratio of 200. I'd rather buy that than a company that's only growing at 8%. That 100% earnings growth can really compound and make up for lost time rapidly. But an 8% earnings growth can take a long time. Those stocks need to get to more realistic levels, and then they'll be very attractive.

Right now I own some Safeway (SWY) in my fund, and I own Gap (GPS), but we're not heavily weighted in those at the present time.

***Do you take valuations into consideration?***

Yes. I don't draw a hard and fast line, but I do compare price-earnings ratios to industry peers. For instance, if the average price-earnings ratio of an Internet company is 500 and there is an Internet company selling at 300, I've found a bargain. Everything's relative. I look at the price-earnings ratios, the dividend yields, the price-to-cash-flow ratios, and the PEG ratios (price-earnings ratios relative to the earnings growth rate).

***Do you buy Internet companies?***

Yes. We're in WebTrends (WEBT) and BroadVision (BVSN). I'm in Cisco Systems (CSCO) and Sun Microsystems (SUNW). Talk about Internet companies—Cisco's the engine for the Internet and Sun is the language for the Internet with Java. These are some great companies and they are going to do well in the future.

***The valuations on those aren't scaring you at this point?***

I could say no, they're not. But yes, they are. Any investor who's been around more than 10 years has got to be a little leery of some of these ratios. I was around in the early '70s, and I remember price-earnings ratios of six. But it is important to be flexible. Now I own companies that have price-earnings ratios of 100 to 200. If I had stuck with saying "I don't want to change because I remember P/Es of six," I would never be in those stocks, and you wouldn't be talking to me now, because I would have had one of the worst-performing funds in the country.

***What would cause you to sell a stock?***

It's very simple, probably the easiest part of my job. Selling is easy because we have our four steps. If earnings drop—bam, good-bye. If suddenly a lot of debt's taken on for no apparent reason, good-bye. If the current ratio really starts to get out of whack, good-bye. Or if I see a lot of management selling, I'm out of there. It's a really simple decision because it no longer fits my buy criteria. There are a lot of companies sitting out there that do fit the criteria, and so I say, OK, let's sell this and buy the one that does fit the criteria. Selling is the simplest thing to me; buying is the more difficult one because I've got to be very selective.

***What if you purchase a company that has met all of your requirements and the stock price just goes nowhere? Do you have any time limits that you put on your stocks to***

***perform?***

I like to give a stock at least a quarter, and if the fundamentals are still good, I'll give it another quarter. If I had a choice, I'd rather hold a company for up to six months to see if it starts to reward my shareholders. Again, if something else comes up, maybe in the same industry, and the numbers are a little better, I might switch. But I don't want to churn the account.

***What about on the upside? Let's say that you're holding onto a stock and the valuations have gone way, way up. The earnings are still increasing, but the stock price is no longer continuing to go up as much.***

As long as the fundamentals keep improving, I'll hang on. I do try to keep trading down to a minimum. Right now, though, we have a relatively high portfolio turnover because if I get into something and I hear that they're going to have a bad quarter, I get out of it. On the other hand, if you look at core holdings, I've held them a long time. That's because I'm searching for the companies that I think I can hang onto for a couple of years. I don't have many losers in my fund—I will get rid of them if things don't work out, and I'll look for something else.

***Is there anything that would cause you to take a greater cash position, or pull back from your current approach?***

I've been in this business since the early 1970s, and I've seen bear markets. We've had a wonderful opportunity in the past decade and we've had a super bull market. If I saw a bear market coming, we would probably tighten up a little bit and not be quite as aggressive in our price-earnings ratios. I would probably have a little more cash for redemptions.

But I think the most important point is that you need to stick with your system. There have been times when growth was out of favor, and I didn't perform as well as other funds because of that. And there will be times when that happens again. You just can't beat the market year after year after year.

When I was underperforming, I reviewed what I was doing, and the stocks I was buying, but I did not change my investment philosophy.

If you stick to a good system, where you're doing solid, fundamental homework, over time you're going to do well. You need to be patient. You can make more money with patience than with brilliance in this market. ♦