A STRUCTURED APPROACH TO INVESTING IN LARGE-CAP GROWTH STOCKS

The year 2000 may be bringing investors back to reality, as average stock market returns thus far have failed to reach the lofty levels of the past few years. A number of more conservative fund managers, though, appear to be treading water quite well, avoiding big losses in a volatile environment while keeping pace with a sideways market.

One fund that has performed relatively well recently, as well as consistently over the long term, is the Alleghany/Chicago Trust Growth & Income Fund. The fund has been among the top 25% of all growth and income funds, and it has outperformed the S&P 500 for the last year, three years and five years. Currently, it has about $570 million in total assets.

In early August, portfolio manager Bernard Myszkowski discussed the management of the fund with Maria Crawford Scott.

FUND FACTS

ALLEGHANY/CHICAGO TRUST GROWTH & INCOME—(CHTIX)

CATEGORY:
Growth & Income

PERFORMANCE: (thru 6/30/00)

Compound Annual Return (%)	Fund	Category
1 Year	10.5	2.7
3 Years	21.9	12.1
5 Years	25.5	16.6

RISK: (relative to category)
High

TOTAL ASSETS: (as of 8/1/00)
$570 million

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What is the investment philosophy used in managing the fund?

We are large-cap growth stock buyers. We spend a lot of time on screening and research, trying to find situations that we feel represent good fundamentals, good valuations, and will provide good growth over the next two to four years.

We have a very structured investment process, and that's led us to superior long-term, risk-adjusted returns. Our portfolios are very focused—generally we will hold between 35 and 40 stocks. So, we don't run an index fund, but we do have good diversification. We believe that diligent portfolio risk management is one of the keys to long-term wealth-building.

The name of the fund implies there is an income component. Is that a consideration?

It is more of a growth fund, although some of the monitoring agencies classify us as growth and income. We've got a number of situations in the portfolio that don't pay any income. However, when we look at companies, we look for earnings consistency as well as the ability to pay a dividend at some point. But it isn't a screening criteria.

How do you start the selection process?

We think investment is both an art and a science. The science part is the screening, and we've got some very specific criteria that we screen on. We use a database that covers over 6,000 companies. The first screen that we use is market capitalization in excess of $3 billion. That cuts down the universe to about 1,500 companies.

Our other screens are relative to the S&P 500. Our second screen is on sales and operating earnings growth: We screen for sales growth and operating earnings per share growth over the past five years that is greater than the average for the S&P 500.

Next, we screen for above-average return on equity for the past five years, and for financial leverage. Here, we're looking for companies that have a long-term debt weighting that is lower than the S&P 500, which is at about 36% at this point.

We also screen for earnings stability. What we do is an analysis of the volatility of quarterly earnings per share for the last five years for the S&P 500 and for each company. We are trying to buy companies that are more stable than the S&P average. In fact, the historical earnings per share volatil-

ity of the S&P 500 is about 7.2%, and for the fund it's approximately 4.5%. So basically, we are searching for companies with greater earnings growth but more stability than the S&P 500 average.

The first screen on market capitalization gets us down from about 6,000 companies to around 1,500 companies. Then applying the screens for sales, operating earnings per share growth, return on equity, financial leverage, and stability typically leaves us with approximately 250 to 300 companies.

From there, we do independent research. We talk to company management, we talk to Wall Street analysts, we talk to buyers, we talk to sellers, we talk to distributors. And then we look at all the fundamentals of the company. You've got to do the work. When our analysts go through analyzing these companies, the way I learned it, is you go to the footnotes of the annual report first because if there are any bodies to be buried that's where they're going to bury them. That's what we're trying to do.

The market cap for the fund is lower than the average for the S&P 500. Do you feel that you can find more value in the mid-cap area, perhaps because it is less analyzed?

The way the market's been, I don't think there are any areas that are under-analyzed. There are hundreds of small-cap, mid-cap and large-cap funds—I really don't think there are any areas that are "undiscovered." But we think that there may be greater growth potential. We're trying to buy larger companies, but when we do see a mid-cap name that makes sense and passes all the screens, we'll do work on them. So, we feel that if we start out at that $3 billion capitalization level, it gives us a bit more flexibility. We're not always buying Coke, Gillette, Microsoft and the big guys, although we do have some of them in the fund.

What types of stock do you like?

There are some industries that just don't make the screen, like the utilities or transportation stocks where there is volatility. Companies that tend to pass the screens tend to be in growth industries, but we focus on the companies rather than the industry. Typically, we seek the best companies in their industry.

Once you find a stock that you are interested in, how do you determine its value?

What we want to do is to buy companies in which the price-earnings ratio relative to the growth rate (PEG ratio) is less than that of the S&P 500. Basically, you divide a company's price earnings ratio by the earnings growth rate projected out over the next two years. On average, this portfolio has a 1.4 PEG ratio, compared to about 3.5 for the S&P 500.

Basically, we are seeking to buy a company that has good growth characteristics, good fundamentals, and good valuations.

How do you construct the portfolio?

That is more of an art. With the senior staff here we've got the ability to look back and see what's happened in previous markets, and the construction of portfolios is based on getting the greatest return for the level of risk that we're taking. We control that risk basically by our weightings. We won't overweight any one stock in the portfolio. In fact, the maximum holding of one issue will be 5%. So if Nokia or Sysco, two of our growth stocks that have really performed well, become 6% or 8% of the portfolio, we'll be forced to cut back or at least take a good hard look at that. That's our first kind of risk control.

The second element is that we won't overweight an industry more that 150% of its weighting in the S&P 500. For instance, technology stocks currently represent about 31% of the S&P 500, and in the fund, technology represents about 38% of the portfolio. We are overweighted in that industry, but nowhere near where some of the other growth stock managers are, some of which have 50% to 60% or more in technology. We could go up to about 45% right now just based on our 150% rule, but we look very critically and cautiously at where the weightings are, and where the values are of these stocks, and we try not to become terribly overweighted in any one industry.

Do you measure the industry weightings relative to the full S&P 500, or relative to the S&P 500 growth index?

We're looking at the S&P 500 index. That may put us out of line with some of the growth managers that have really stressed technology stocks. But it helps us, as in the past several weeks when technology stocks have been weak on some basis. If you look at what's happened to our portfolio over this year, we're up about 5.7% versus the S&P 500, while the average growth stock manager is slightly off.

Do you try to underweight or exclude certain industries?

We don't specifically exclude industries. However, if they don't make our universe we won't use them. For instance, in the utility industry, there are only a few companies that even pass our screens, compared to about 9% in utilities for the S&P 500. Right now, we've got one holding in the utility industry, AES, which is a utility gatherer.

What about the number of holdings within a particular industry?

There is no set limit. But let's just assume that we're talking about technology. If we feel that we ought to be overweighted in technology, you can't hold 20 technology firms in a 40-stock portfolio. So it is really a question of constructing an approach to get the best compa-

nies and weight them significantly enough so that they produce a return for you, but don't become overweighted.

We don't really ever want to hold more than 40 stocks in the portfolio, and we want to have diversification across a number of industries. That forces you to take a close look at getting only the best ideas that you can into that portfolio. I don't want to sit there and hold 25 tech stocks and have 2% in each one. They could go up and not really mean a lot to you.

What would prompt you to sell a stock?

The opposite of everything I said in terms of our purchase criteria. We don't want to hold stocks that don't make our screens, so that if the revenue and earnings per share growth has fallen, if earnings stability gets out of line, if things such as that happen, we would sell.

Of course, we try and stay on top of these situations as much as we can. And we want to continue to talk to management, because unless they're lying to you, you should then have a pretty good handle on what's going on. We never use price targets, period—we do not say that if the stock appreciates 18% over the next four months, we're going to sell it or whatever. Basically a change in fundamentals, a change in valuation or a change in what's going on with the company could prompt a sale.

And that's not to say that we buy the best things all the time—we've bought some clunkers. We just sold Computer Associates in the last month or so. We held Carnival Cruise Lines, which we've sold.

Also, as I mentioned, we would start selling if a stock becomes too large a holding in the overall portfolio.

Sysco is a good example, because we've had to sell it a couple times. Sysco has appreciated significantly—if we would have held on to it since the day we originally bought it, it would probably be 30% of the portfolio right now. You're continually looking at those situations, and you reduce positions because you don't want to get into a spot where 20% of the portfolio is in only two stocks.

On the other hand, sometimes a drop will prompt us to put more money into it if we feel that the fundamentals still make a lot of sense.

Some of the technology stocks that the fund holds—Nokia and Microsoft, for instance—still have high valuations. Do you continue to hold them because, in your opinion, they have reasonable valuations relative to their growth potential?

Yes—the key is that we feel it is relative to their growth potential. You've got to look at each situation individually and say to yourself, "Would I buy more of this today?" And if you would, you keep holding, but if you wouldn't, you shouldn't own it.

But keep in mind the top 10 holdings in this portfolio now: DNC is 5.5% of the portfolio, Sun Microsystems is 4.3%, Sysco is 3.8%, Cisco is 4.2%, Nokia is 3.7%, AES the utility is 3.7%, Microsoft is 3.3%, Cardinal Health is 3.3%, GE is 3.1%, and Harley Davidson is 3%. So, even among our top 10 holdings, they're not all technology—you have a utility, you have General Electric, you've got a motorcycle firm, a drug distributor, and a food distributor.

But even in the technology holdings, we need proven growth. I refuse to buy companies that don't have earnings. I don't know how you could buy an Amazon or something like that. It may be great for a year, but you've got to have something to hang your hat on. You've got to have something that makes you say "I want to buy this company," other than simply a Morgan Stanley analyst saying it's a great buy.

Also, keep in mind that our portfolio turnover is extremely low, around 25% to 30% annually. That means that we're only turning over one-third of our portfolio each year. All of our work is done on a long-term basis—we want to hold onto a stock for at least two to three years. That also helps in terms of tax-efficiency, which is another factor that we always take into account. We've been remarkably tax-efficient during the long run as well.

We feel that the most important thing in managing the fund is consistency. Last year, we did not do well relative to other large-cap growth funds, but if you look over a longer time period, it's done very well, and we have done that without participating in the technology pool to as great an extent as the other growth funds. ✥