A SEARCH FOR GROWTH AMONG THE WORLD'S LEADING COMPANIES

FUND FACTS

REYNOLDS BLUE CHIP GROWTH (RBCGX)

CATEGORY:
Growth & Income

PERFORMANCE: (thru 3/31/99)

Compound Annual Return (%)	Fund	Category
1 Year	49.9	4.7
3 Years	41.9	18.6
5 Years	32.7	18.4

RISK: (relative to category)
High

TOTAL ASSETS: (as of 3/31/99)
$270 million

CONTACT:
Reynolds Funds
800/773-9665
www.reynoldsfunds.com

Defying expectations have been the large capitalization growth companies that have led the way in terms of performance for the past few years.

One fund that has been a leader among large-cap growth funds is the Reynolds Blue Chip Growth fund. The fund has been among the top 25% of all growth and income funds for the last one, three and five years; for 1998 the fund returned a stellar 54.1%, compared to 28.5% for the S&P 500 and 13.5% for the category average. Currently, it has about $270 million in total assets.

In late March, president and portfolio manager Frederick Reynolds discussed the management of the fund with Maria Crawford Scott.

What is the investment philosophy of the fund?

Basically, our objective or philosophy is to be a long-term investor in the world's best companies. By the best, I mean companies with good management, good financial structure, great products, great R&D (research and development), good unit growth, and a good share of their market. By investing in these kinds of companies, it puts the probabilities on our side that we will do well over time with a lower level of risk. Of course, occasionally things can happen to individual companies, but to the extent that we own 60 or 70 of the best companies, the aggregate will come through.

What kinds of companies are you typically invested in—mostly large cap?

Typically, about 80% to 85% of the fund will be in companies in the Standard & Poor's 500. But we've also been very good at finding companies very early and having them in the fund before they are added to the S&P. For instance, I was very early on Microsoft, Wal-Mart, Home Depot, Office Depot, and most recently America Online. When I bought Microsoft, they only had the DOS operating system, but that was a pretty big thing and it was a much bigger thing to have than, say, Lotus 1-2-3, which was just an application software program. I bought Microsoft when they first went public in 1985 for other accounts. The Blue Chip fund wasn't started until 1988, but I bought Microsoft right away when I started the fund, and I've probably bought Microsoft 300 different times over the last 10 years as new money has come in.

Another interesting story was when I bought Wal-Mart. When I bought the stock, Wal-Mart already dominated competitors in small towns in the U.S., but there were reams of research reports out there questioning whether they could do well in middle-sized towns. After visiting with them, my thought was that it was obvious that they could—they have great management, great inventory controls, the layout of the stores was great, and they sold a nice discount product.

Many times these mid-cap companies are firms that are already dominant in what they are doing, it is just that people don't appreciate how large they can get. I admire a company that sells a low-priced product that can sell to the masses.

How do you identify the 'world's best' companies?

There are a lot of different variables. I am looking at their products. In other words, do I think that they've got a better product? For example, years ago we owned Motorola, but Motorola fell behind in much of their phone technology because over the years, most of the industry had gone to digital.

All of a sudden, when you compared a Motorola to a Nokia phone a few years ago, you saw that the Nokia was far better—it had better attachments, it worked better, and it had better features. And that was one of the reasons we switched from Motorola to Nokia—it was the actual product that got us there.

Some products don't need to change. If Coca-Cola happens to have the best brand name in the world, which it does, they don't need to come out with many other products, although they did come out with Diet Coke and by mistake almost threw away their old formula.

I look at the research a firm does. In the drug industry, Merck and Pfizer have great research labs. If anybody is going to come up with new products over time, it is more likely to be Merck and Pfizer as opposed to Bristol-Myers. Distribution is another important factor—how good are they at distributing that product worldwide?

I also do some statistical analysis. For instance, I want companies with a high return on equity (net income after all expenses and taxes divided by stockholder's equity), which means that they don't have to turn around and sell stock and dilute earnings. And although it is OK to be slightly leveraged on the balance sheet—say 30%—if a company is 60% to 70% debt, profit margins can get hurt when times get tough.

While I look at all little factors and variables, in many cases it just might come down to the fact that the company is the largest in terms of sales. You can analyze forever and look through tons of data, but usually it is not the No. 8 company in terms of sales that's doing all of the better things, unless it is a brand new company in a brand new industry.

Other things I look for are companies that are predictable in terms of earnings—I'm more likely to have a higher weighting in the fund of companies that have more predictable earnings. Here's a good example. Now, there is nothing wrong with Hewlett Packard—it is a wonderful company, its got great management, they lead in terms of printers, but doggone if that company won't disappoint at least once every six or seven quarters. I don't even know if it is necessarily their fault—it might be the industry they are in. But I very rarely over the years will have an above-average weighting in Hewlett Packard. Yet, I may have an above-average weighting in, for instance, Microsoft, even though now they are involved in an anti-trust suit.

You mentioned that you are looking for the number one company in the world. Do you invest in foreign stocks?

Yes we do. Of course, about 70% to 80% of the best companies in the world are headquartered right here in the United States. And almost any company that is a leading company in the world that isn't headquartered in the U.S. will still trade here using ADRs (American depositary receipts). Now that means two really important things: First of all, to be an ADR they have to state their earnings using U.S.-accepted accounting principles, which are some of the most conservative in the world. Second, their earnings are denominated in dollars. Over the years in the Blue Chip fund, we have owned many ADRs—Sony, Toyota, and Hitachi back when the Japanese were doing well, Nestle's and Unilever just to name a few.

What about broad industry sectors—do you favor certain areas over others?

We tend to stay in industries that are big growth areas—the growth areas of the next 10 or 20 years. Now, if you and I were talking in the 1950s, we might have talked a lot about plastics, and I might have owned a bunch of chemical companies. But the growth areas in the next 10 or 20 years are going to be more like drugs, computers, computer software, telecommunications, and retailing. We also have certain basic companies in the portfolio that make a lot of consumer non-durables that I can really count on during tough times. Their earnings will slow, but they won't slow as dramatically as a durable company producing high-priced products like an auto company. So we have a lot of what I call 'kitchen and bathroom' companies that make products used up by you and me day after day in good times and bad—Coke, Sara Lee, General Mills, Colgate-Palmolive, prescription drug companies like Merck and Pfizer, and over-the-counter drug companies like Johnson & Johnson and Tylenol—that type of thing. Now these aren't necessarily very high growth companies. But if I can find a company that's got 'only' 13% growth, but it is very dependable growth, well three years from now those earnings are 49% higher—that's pretty good stuff. So we will mix into our portfolio some solid 13% growers that we can count on, along with a few 25%, 30% growers like America Online or Yahoo in the Internet area. If you put the whole thing together, we haven't got too much volatility or added too much risk into the whole equation.

Are there any industries that you avoid?

Well, there are some that I really haven't owned for a long time. One of them would be steel. We have owned some slower-growing industries, but steels are just too slow. We haven't owned much in the way of electric utilities. Now, no one likes a regulated industry because they're not free to control their destiny. Telephone utilities are participants in the worldwide growth of telecommunications, and we do own them. But there really isn't much growth in the demand for electricity, so we haven't owned electric utilities for years. And we haven't owned much in trucking.

What about valuations?

I look at many variables, but one important ratio I look at is the price-earnings ratio relative to the earnings

growth rate. The price-earnings ratio is the numerator of the equation, the growth rate is the denominator. You have to relate the multiple to the growth rate to make comparisons meaningful. For instance, let's say that Heinz is growing at 15%, and selling at 15 times earnings—that's a one-to-one ratio; if Microsoft is growing at 30% and selling at 30 times earnings, that's one to one. On that basis, they are both equally attractive. But if Microsoft grows at 30% and holds a lower multiple, and Heinz grows at 15%, half the rate of Microsoft, and holds the same multiple, Microsoft is a better buy because you've got 30% earnings growth as opposed to 15%.

Another thing I look at very closely for valuations is interest rates. Interest rates are important for two reasons. Number one, it is the risk-free return that stocks have to beat. Let's say right now I could get 10% risk free in a one-year Treasury. Well, then maybe we don't need so many of these Reynolds Blue Chip stocks that we've got, because we'd have to do 13% to 14% to make it worthwhile. However, right now, interest rates are about 5% as your risk-free return, so that is good for stocks.

Number two, as shareholders we own the whole company in the aggregate—we own the earnings of the company, which then can be paid out in dividends or reinvested. And if you think about it, we're basically trying to value a dollar's worth of earnings earned by Procter & Gamble or any of these companies two or three years from now, discounted back to the present time. The higher the level of interest rates, the lower the present value. Stated differently, by the time Procter & Gamble earns a dollar a year from now, if inflation is 9%, that only buys $0.91 worth of goods and services, whereas if inflation is 1%, which it is right now, that buys $0.99. So in a period of low interest rates and low inflation, stocks are worth a lot more.

In a period of high inflation and high interest rates, I've found that a 'world's best' company is a good value at a price-earnings to growth ratio of about one-to-one. But at a time like this, when interest rates are very low, many of these companies have a ratio of two-to-one, and I've found that to be good value.

Right now, conditions remain fairly ideal for investing—we're in a period of slow growth in the economy, with low interest, and a Federal Reserve board that is fighting inflation—doing a great job there.

The fund has a very low portfolio turnover.

Yes, and that makes it very tax-efficient, and we feel that's very important. We have about a 15% to 20% turnover. We are able to do this because when you are investing in the world's best companies, you can make a long-term bet on them and they will come back and keep growing over time.

What would cause you to sell a stock?

We will sell if the price-earnings ratio relative to the growth rate gets too high.

If the fundamentals are eroding, we are going to lighten up—Motorola being behind in digital phones is a good example.

Another example is when the president of Quaker Oats bought Gatorade a few years ago and he paid a pretty cheap price for something that went on to become a billion dollar product for them—smart buy. But then I guess he felt he could walk on water and he went out and paid way too much for Snapple. We sold our Quaker Oats right when they first started talking about buying Snapple, knowing that might cause some problems.

Do you always remain fully invested?

I will go to a modest cash position—we've been to 25% a couple times. I am not a big market timer, but I may raise some cash when things get bad out there, if there are really high valuations, or if I can't find something to buy and I've got some fundamental erosion. Then I may raise a little cash because cash is helpful to cushion things. A good example is right now, because the fund has grown dramatically: I've got about 9% cash in the fund, which is rare. A lot of money has come in, and I'm just taking my time spending it.

What is the biggest risk that someone is taking when they put their money into the fund?

Their risk is just plain old market risk—the market could get into a correcting phase that lasts a while. But that's the advantage of our stocks—they won't be affected as much. Our stocks will go down a little bit because of what I call 'guilt by association.' But when times get bad, I often get through in good shape with these classic companies because they are real survivors. I don't have to do much in the way of changing things around, and many times I can use it as a buying opportunity.

But in the meantime, this fund could go through a period when there is a bad stock market where we aren't making people a lot of money. There is no free lunch in the world. Stocks go up 70% of the time. They are a great place to be, but you have to appreciate that once in a while they'll fluctuate.✦