*An Interview with George A. Mairs III, portfolio manager, Mairs & Power Growth Fund*

# Seeking Growth Companies at a Good Value, With a Midwest Slant

*How does a new name suddenly pop up on a list of long-term performers? Most publications that track mutual funds—including "The Individual Investor's Guide to Low-Load Mutual Funds"—have minimum size requirements for the funds. Small funds will not make the listings until they grow larger, but nonetheless they have a portfolio track record that can be examined once the fund reaches the required minimum in total assets. And sometimes those track records turn out to be quite good.*

*The Mairs & Power Growth Fund is a case in point. The fund's relatively small size (it had assets under $50 million until 1995) has kept it out of many listings until recently, but its performance record has been impressive, both long-term and in more recent years. In the most recent Low-Load Guide, it appears among the top 50 performers for the past 10 years, 5 years and 3 years (through year-end 1996). Its average annual return for the last 10 years was 17.2% compared to 15.2% for the S&P 500 and 13.9% for the average growth fund, while for the last 5 years it returned 19.3% annually compared to 15.1% for the S&P 500 and 14.3% for the average growth fund; over the last 3 years it returned 25.8% annually compared to 19.6% for the S&P 500 and 15.7% for the average growth fund. In 1996, the fund's return was 26.4%.*

*Currently, the fund has about $190 million in total assets; it is a no-load fund.*

*In early March, fund president and portfolio manager George A. Mairs discussed the management of the fund with Maria Crawford Scott.*

***What is the investment philosophy of the fund?***

Basically, we are a bottom-up fund. We tend to look for attractive companies, particularly in this upper-Midwest area, at prices that appear to have some value. Of course, we are a growth fund—we're looking for growth companies—but we like to buy them on a valuation basis. Our tendency is to want to buy stocks on dips rather than on strength.

***What stock universe do you select from?***

Well, 80% of the stocks in our portfolio are upper-Midwest companies, so it would be fair to say that much of our universe is upper-Midwest. On the other hand, there are certain areas we want to be represented in, such as healthcare and pharmaceutical companies, and we have to go elsewhere to find them, so we don't restrict ourselves to simply upper-Midwest companies.

***Why do you focus so heavily on the Midwest?***

Well, it's where we are. This is a 65-year-old firm and we know the area up here very well—we're quite familiar with the companies that have been operating here, and we feel that, if there is a particular advantage that we can bring to our work, it's our knowledge of the business community here.

***What areas do you seek investments in? Do you seek broad industry representation, for instance, similar to the S&P 500 weightings?***

No, we pay relatively little attention to the industry weightings in the S&P 500; there are many industries where we have little or no representation—for instance, basic industry. We tend to look for companies that we think have better-than-average return on equity [net income divided by stockholders equity] and better-than-average profit margins [income divided by sales] and better-than-average growth prospects. These are the kinds of companies in which we wish to invest almost irrespective of the industries in which they operate.

***What is the size range of the companies in which you invest?***

About 53% of our portfolio would be large capitalization, which is to say $5 billion or greater in market capitalization [share price times number of shares outstanding]. And the other 47% would be small- and mid-cap. We want to be represented in all three of these capitalization areas, but we want the lion's share of our fund to be in large-cap stocks.

***How small are the small-cap stocks?***

The smallest capitalization that we would have would probably be $100 million.

***What critieria do you use for selection; for instance, what kinds of screens do you use?***

---

*Mairs & Power Growth Fund is located at W-2062 First National Bank Building, 332 Minnesota St., St. Paul, Mn. 55101; 800/304-7404.*

It's done on a very subjective basis, but we are simply looking for a well-managed company that is seasoned, with an established growth record—a company that has shown fairly predictable growth over a 10-year period, with earnings growth substantially above the S&P 500. For instance, if the S&P's earnings are growing at 7% annually, which we think they probably are, we would like to find companies that we think can certainly do 10% or even 12% to 16% and in some cases, more than that. Basically, we want to find companies that are growing substantially faster than the S&P.

We also look for companies that have a better-than-average return on equity and profit margins. Typically, these would be companies that have strong franchises.

A good example is Merrill Corp., which is a financial printer headquartered here in St. Paul. We've followed the company for some time, and they are the third largest financial printer in the United States today. It's around 20 years old, and it has grown substantially faster than the printing industry in general, and we think they've established for themselves an important franchise in the financial printing business.

So, these are the kind of things that we're looking for—companies that can grow faster than the industry, increase their market share and do it with a higher-than-average return on equity.

***In terms of "buying value," you mentioned that you like to buy on dips. How do you accomplish that?***

First of all, we establish the universe that we're looking at—companies that we find attractive. And then we tend to buy 'start' positions when we think that an attractive company is currently undervalued relative to the market. Basically, the valuation becomes a subjective thing, but we are not momentum players—we're not buying stocks because they are strong. We are buying stocks because we think that they provide some value in the current market environment.

***And how do you value them?***

Basically, we use price-earnings ratios. We pay far more attention to price-earnings ratios than we do to price-to-book or dividend yields. I think that historically, it's a far better benchmark. Dividend yields today are very low for a variety of reasons that don't necessarily relate to basic valuation.

***What kind of trade-offs do you make—how much do you give up on valuations in exchange for more growth, especially among smaller growth firms?***

Typically with small-cap stocks, we're looking for greater undervaluation—small caps are selling at lower multiples today than large caps, and so we would expect to buy small-cap stocks at lower valuation levels.

***You mentioned that you look for companies that are well-managed. How do you judge that—from the financial position of the firm?***

Yes. The higher-than-average return on equity and better-than-average profit margin would generally reflect strong management, as would a strong franchise.

***In the fund's prospectus, it states that you look at institutional interest, especially in the mid-cap and the smaller-cap area. Do you find it profitable to invest in areas that other institutions are not in?***

Yes, we do. I think sometimes the fact that there's little or no institutional ownership of a small-cap company provides opportunity because chances are, the stock is selling at a multiple that reflects little institutional interest. We have at least three stocks in our portfolio where there currently is no institutional brokerage followings at all—no research reports. And typically, when institutional investors start picking up coverage, the companies are no longer undiscovered. So from time to time, we find companies that have been relatively undiscovered by Wall Street, which we do think gives us some opportunity. It's not the main thrust of this fund at all, but I think in the small-cap area, it does provide opportunity.

***How did you find those companies?***

Simply because we've been aware of the companies in this area. They obviously are not completely undiscovered, but unfollowed, let's say, by institutional investors and I think the advantage that we have is we know the business community here very well.

***Do you do any market timing?***

No, we are not market timers. We look at valuations for specific stocks in the portfolio, and we don't worry too much about the valuation for the overall market, although obviously it's a concern. But we tend to be fully invested throughout market cycles.

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

Typically, we lighten up rather than eliminate positions. If we felt that there had been a basic change in the fundamentals of a company, then we would eliminate it. For instance, six or seven years ago, we eliminated IBM pretty much on that basis. We felt that the prospects for the mainframe industry were deteriorating, so this was a situation where we thought the business conditions for the company had changed substantially and therefore we decided that we simply no longer wanted to own the stock.

But, usually, what we do is reduce our positions when we think they are overvalued relative to the overall market. In other words, recognizing that these are long-term growth companies and that the overvaluation probably is temporary, we'll reduce the size of stocks that've outperformed the market, and not infrequently, take that cash and add it to some of the positions that have underperformed.

***So, once that company comes back down in terms of valuations, you can put money back in it?***

Exactly. In fact, we've done that with Medtronic in recent months—when the stock seemed to be fully valued, we reduced the size of the holding, and then in recent weeks, when the stock was under some selling pressure, we put back in the money that we had taken out.

***Typically, how long would that cycle last?***

Well, it would vary, but I think it would be a matter of maybe six or nine months.

***Looking over your holdings, it appears that you tend to take fairly large positions in each holding.***

We own 33 stocks in the fund, which is a fairly compact portfolio. But we think of 5% [of fund holdings] as being something of an upward limit, although we violate it periodically when the market does well on a particular issue. We have a decent-sized position in each stock. And I'm inclined to think that portfolios with large numbers of issues tend to perform less well than more compact portfolios such as ours.

***In terms of performance, your long-term track record is very good. To what do you attribute that?***

We've done very well, and the last five years particularly has been a fine period for us. Our philosophy hasn't changed at all, nor have the number of stocks, or the particular issues changed very much over the years. But, for a variety of reasons, many of the stocks in the portfolio have done rather well. One of the strongest areas has been the financial stocks. We happen to own fairly large positions in both Norwest and First Bank, and when we established these positions over 30 years ago, these were simply our local bank holding companies. But they've become two of the most outstanding super-regional bank holding companies in the country.

***Your portfolio turnover is very low—3% to 4%.***

The average holding period for our fund is well over 15 years right now. That would be average.

***The fund has grown rapidly in recent years due to your performance. Do you expect it to become a little bit harder to find some of the companies you seek?***

I really don't. I think that we're not at a size where liquidity in small-cap stocks becomes a problem for us, although if we become much larger, it might be. But basically, over half of our assets are in large-cap stocks, so that we can be patient as we attempt to accumulate the smaller-cap issues.

***What is your outlook for the market?***

We tend to be positive on the outlook for the market. The economy is doing beautifully and we feel it can expand for another couple of years or perhaps even longer. There have been two periods of business expansion longer than the current one, which leads us to believe there's no reason this expansion can't go on for another couple of years. Therefore, we've got a splendid business environment and we think that valuations are pretty much in line with periods when inflation has been very low, as it seems to be today. So we are not troubled by overall valuations. We can always identify stocks that look too expensive for us to want to own, but basically, we think that there is a valuation underpinning in this market today. We're particularly pleased with the strength in corporate profitability and we think this could continue on into the future with stronger than anticipated earnings growth.

This really has been the story of the market for the last four or five years. Earnings have come through ahead of expectations, and we think that will continue to be the case in the current year. I think earnings expectations on the part of Wall Street for the current year are pretty modest, as they were a year ago, and we think that earnings can surprise on the up side.

***You have been in the business for a very long time, and gone through a number of severe bear markets.***

I've been in the business for 45 years. I entered in 1952.

***Do you think it's bothersome that a large number of individuals or institutions have not experienced a severe bear market—are they misjudging the risks involved in investing in the stock market?***

I'm not overly concerned about this. We had a pretty sloppy market in 1990, and I think that really was the last time that we've had a bear market. But I think that an awful lot of the current participants in the market have been here for 10 years. As far as the smaller shareholders are concerned, I think these people probably are more patient than they are given credit for. Time will tell.