Approach focuses on buying high-growth companies relatively early and holding onto them for the long term.

Investing in Long-Term Growth With an Eye Toward Quality Earnings

An interview with Gloria Santella, portfolio manager, SteinRoe Capital Opportunities Fund

This month's Mutual Funds Workshop (pages 16-19) takes a look at non-sector aggressive growth funds. As John Markese notes, these funds often are the rockets of the mutual fund industry, reaching orbital return heights during the good years, and crashing to the earth during the bad. Not surprisingly, aggressive growth funds vary in terms of what fuels their performance, with some, for instance, coming close to being quasi-sector funds.

One aggressive growth fund that has performed well this year—and that tends to limit its holdings in any one sector—is the SteinRoe Capital Opportunity Fund. The fund was among the top 20 non-sector aggressive growth funds based on one-year returns through September 30, with a return of 37.4%; its three-year average annual return (through September 30) was 23.5% and its five-year average annual return was 25.1%. (Its 14th rank did not place it among the top 10 listed in the Mutual Funds Workshop article, although its three- and five-year figures topped several on the list. Performance figures of the top 10 non-sector aggressive growth funds can be found on pages 18 and 19] for comparison.

The fund currently has about $300 million in assets.

In early December, portfolio manager Gloria Santella discussed the fund and its performance with Maria Crawford Scott.

What is the investment philosophy of the fund?

I consider ourselves to be a small to mid-cap aggressive growth fund.

Morningstar divides the market capitalizations at under $1 billion for small and $1 billion to $5 billion as mid-cap; our median market cap now is about $1.2 billion, and we usually hover around the $1 billion level. So, by that definition we're right on the borderline of small and mid-cap.

We have a long-term philosophy, so we tend to buy stocks when they're small, but because we try to hold them for long periods, they end up being in the mid-cap area by default. Our investment focus—when we're buying ideas—is more in the small-cap area. That really derives from our philosophy. We're trying to build a long-term product that people could be comfortable with and I think a lot of people are reluctant to invest in the aggressive growth area because of the inherent volatility in the area, which is unfortunate because this is a rewarding area to participate in. We're trying to get the right balance between growth and volatility. To find the high growth, we turn to small caps, because the smaller a company is, the easier it is for it to grow. Our focus, though, is on finding companies that we can own for the long term and if we're successful and they appreciate, we have to be able to hold them as they go into the mid-cap area. So we don't screen necessarily on size—we have a very broad range of market caps and the fund will range from $200 million to $5 billion.

So, our approach is to buy high-growth companies relatively early and hold on to them for the long term. When you do have bad markets, the thing about owning long term growth is that the earnings then provide support in a down market. And not only does it provide support, but then the earnings are a catalyst so that those stocks would be the first to rebound. That's why it's so important to have quality earnings and the long-term growth span.

What do you screen for—earnings growth?

Yes, we're really earnings driven. We look for a minimum of 15% earnings growth, but the portfolio typically runs higher than that.

Over what time period?

Three years, but what's more important is the sustainability of the growth. I want to find companies that grow at a higher rate quarter after quarter, year after year, consistently. We want to see a high probability that they'll achieve their numbers.

What do you look for to reflect "sustainability"?

There are two characteristics that we find in these kinds of companies. First, our companies would be targeting a very large market opportunity or they would be in a very

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rapidly growing market—for a company to sustain a high level for many years, it has to be going after a large market or else it would penetrate its market too quickly and then the growth would diminish quickly. Second, we look for companies that are going after big ideas and that have the ability to execute against that opportunity. Here we look at their strategy for growth, competitive position, and their infrastructure in terms of what they have and what they'll need to grow in the future.

Most of the companies we buy are somewhat developed already; they're not in the speculative stage. They have a professional management in place, they have the information systems in place, they have their direct sales force—there's something there to work with, on which they can build and grow, but there is still a lot of high growth ahead of them. The risk is minimized by having a company with a little bit of a track record already in place.

Do you project growth for the companies you're looking at?

That's something we spend a lot of time on. We make projections and listen to what the company's targets are. Then we closely monitor the firms on a quarterly basis to see if they're meeting expectations that they set for themselves. It's very important to us that they at least be able to meet their own expectations.

Is this at the point where you've already purchased the stock, or when you're still considering it?

We'll make projections and have earnings estimates for three years out when we buy them. After we own them, we monitor quarterly.

Do you pay attention to what other analysts are projecting in terms of earnings estimates?

We talk to analysts all the time, and after you've owned a stock a while, you know which ones are really good—who's been right—and then you tend to look at their projections first.

Would you avoid a stock if you thought too many analysts were following it?

No, and I think that's another thing that gets a bad rap—stocks being overfollowed. If you have a good company and if it's going to grow for a long time, that's fine. To me, there's nothing wrong with another level of scrutiny out there.

Of course, a value approach tends to seek underfollowed stocks. But a lot of times there's a reason why stocks aren't followed. Information's so instantaneous, it's not like it used to be when there was more inefficiency in the market.

What about price—will you pay anything for growth?

No. Our objective—our required return—is a minimum 15% over three years. The way we determine that is to take that three years' earnings estimate and use the price-earnings multiple, based on historical price-earnings ratios, to give us a future price [to compare to the current price], and, as I said, the return must be 15% over three years.

What tends to knock most of the companies out of consideration?

I think the lack of visibility on the earnings, the risk.

One of the things that we're trying to do is moderate the risk in a portfolio and the biggest source of risk in an aggressive growth portfolio is earnings risk—when earnings disappoint. If it's not a business that lends itself to sustainable growth, and if it's a company that doesn't have a good track record, it doesn't have a good competitive position, or it's in a particularly competitive industry, we tend to avoid it to start with.

And one of the reasons we will sell a stock is if they have disappointing earnings, although hopefully we catch that beforehand, which is one reason we track the trend so closely. So, if we see a deterioration in margins that we're not expecting, and we don't really buy the company's explanations for that deterioration, we'll sell. We rarely sell on price because it's really more important that you have the earnings growth compounding over time. It's such a powerful driver of stock prices that I'm really more concerned with a company not meeting expectations than if it gets overvalued on a short-term basis. I think the risk of being out of a good stock is much worse than having overpriced stocks in a portfolio temporarily.

What about a company that has outgrown its growth, so to speak?

Then it would fall below the 15% earnings growth requirement. We had an example like that, although this goes back some time: We owned Mattel for quite some time, going back to '89, and the company did really well but it became very big. I don't remember exactly when we sold it, but the growth rates fell below 15%, so we sold it, even though the stock went on to be a pretty good stock after that. Sysco is another example—it's a firm that we bought in '91 and it was a small-cap stock at the time. It did really well over the years and it got to be somewhere around $7 billion in market capitalization, so it just got too big.

Also, we limit the size of our individual holdings to 5% of the total portfolio, so if a stock does appreciate beyond 5%, I'll trim it back. We also limit our industry exposure to 25% in any one industry, so that forces us to trim as well.

For example, this summer I had to cut technology because it reached 25% of the portfolio. That's another means of monitoring risk, because in the aggressive growth area when a sector is in or out of favor, you can get those really wide swings where stocks go to extremes; we limit that with a limit on industry exposure.

What are your industry definitions, and what areas are you in?

Our definitions are pretty broad. The fund has technology, health care, business services and specialty retail. We tend to hold the same sectors because there are only a few places where you consistently find growth—we don't do cyclical investing. So, we always have business services because those companies tend to have high recurring revenues; we always have technology because that's where the growth is; we always have specialty retail even though the consumer outlook may be good or bad, because there's always a new concept with high unit growth, like a Starbucks.

The factors don't really change much. And the good thing about having the industry limit is that it forces you to look to other areas for attractive ideas. I think it would have been easy to be 40% in technology this year. But with my 25% limit, I had to be particularly selective with what I owned and it forced me to put the money in other areas that weren't overheated. And I think that's really helped us, especially recently, in the last few months when technology's been more volatile.

How do you view a current holding, such as Starbucks, which has done well but also has expanded so much recently? How do you evaluate its future growth—is there, for instance, a danger of overexpansion?

No, I don't think so because there's still high unit growth potential for them. Plus, they're getting into new product areas—they're working on several joint ventures, one is with Pepsi for a coffee drink product to be sold in the stores. Also, this company has really good infrastructure in terms of buying capabilities and their vertical integration, and they have good management infrastructure in terms of having district management set up nationwide. So, there's a lot there—more than meets the eye.

Do you talk very much to the management of the firms you own?

There's a lot of contact, but it's not necessarily one-on-one. Companies are doing quarterly conference calls now, so the investor relations effort on the part of companies has improved tremendously over the last few years. I go to a lot of brokerage-sponsored conferences, where you can go and hear a lot of companies at one time. The industry conferences are especially useful because you can hear a number of company approaches to a particular problem or to a particular issue.

Most of the time, though, I need to know what a company's strategy is, what its plans are, and then I look at their record. I assess the probability of whether they can achieve what they say they are going to do, and then we track them to see if they do it. The numbers tell me just as much as anything.

Would you ever move heavily to cash?

No, not to time the market or anything like that. I try to keep the cash at about 10%. We're fully invested most of the time.

Your performance this year has been very good. To what do you attribute that?

Well, I did the performance attributions through September 30 for the fund's board, and we had positive contributions from every sector. Technology was up with 23% of the gain, and the other two areas that were good were business services and health care. But, there were other areas to make money in this market.

I just think that the earnings eventually carry the fund through, and when the market goes down we use that as an opportunity to upgrade the portfolio—we go out and we buy the best names that we can at bargain prices. I think that's when I can really add value.

Were you surprised by the extent of the bull market this year?

No, not given the strength of earnings, particularly since we were coming off a flat year. What amazed me, though, was the strength of the earnings, because we track them very closely relative to expectations. Normally I'll have a few companies report earnings above expectations, while most will report in line and a few will be below, but during the first quarter, 38% of my companies reported earnings that were above expectations. I had never seen earnings so strong.

What is your outlook for next year?

I think for the market in general we'll see slower growth—growth will moderate a little bit. But I think that's really positive for the aggressive growth group because there are two things going on there.

First of all, our earnings—we'll always be able to find high earnings growth because our companies' growth tends to be independent of the economy, driven by innovation or advancements in technology. So our companies will have their normal 25% to 30% growth that we always have, but the overall economy's growth will slow, so I think there'll be a scarcity of high growth companies and people will be willing to pay for them then. I think not only more earnings will be there, but you will see an increase in multiples, which could be very positive.

And then we also have a good interest rate environment. I think that looks very good for aggressive growth.