BALANCING THE TRADE-OFFS: A SEARCH FOR VALUATIONS AND GROWTH

FUND FACTS

PBHG MID-CAP VALUE FUND (PBMCX)

CATEGORY:
Aggressive Growth

PERFORMANCE: (thru 3/31/01)

	Fund	Category
Compound Annual Return (%)		
1 year	14.9	(29.5)
3 years	22.0	3.9
5 years	na	8.3

RISK
Low

TOTAL ASSETS: (as of 6/1/01)
$347 million

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The market environment over the last few years has gyrated wildly between two types of investment approaches, with the market swinging first in favor of those that strongly emphasize growth, to more recently favoring those that emphasize deep value.

But not all investment approaches view "growth" and "value" as contrasting styles. And many of the funds that have had the most consistently positive returns over this time period have had stock portfolios with both growth and value characteristics.

One fund that has done particularly well over this time period is the PBHG Mid-Cap Value Fund, a relatively new fund that was started in 1997. It follows an approach that balances both short-term and long-term growth against valuations, looking for a reasonable relationship between the two. This balanced approach has allowed it to earn impressive and consistent returns during some very tough market environments. The fund is among the top 20% for the last one-year and three-year periods through March 31, and it is among the top stock funds ranked by risk-adjusted return.

Currently, the fund has about $347 million in total assets.

In early June, portfolio manager Jerome Heppelmann discussed the management of the fund with Maria Crawford Scott.

What is the investment philosophy that you use in managing the fund?

We use both quantitative and fundamental analysis to find companies that exhibit the best trade-off between value, long-term growth, and near-term business dynamics.

So, for instance, I will screen for companies that have the right quantitative characteristics for good valuations or long-term growth, or even near-term business dynamics, where the quantitative measure would be, for instance, an earnings surprise. What we do then is verify that those quantitative measures are pointing in the right direction by doing fundamental research—for instance, making sure the company has new products in the pipeline, it doesn't have customer concentration risk, it has a strong management team that has executed well in the past, and that it is gaining market share with top-line growth that's driving the bottom-line growth.

What benchmark do you use to compare yourselves against?

We use the S&P MidCap 400 index as a benchmark, and I stay within roughly 10% of the sector weights, so that we don't have a huge sector bet in the portfolio. In addition, I pay attention to the market-cap breadth and depth of the benchmark to make sure I have exposure to the different market-caps in the mid-cap range. And I stay fully invested—I don't try to time the market. The final thing I do is to make sure I own 100 to 120 companies, so that takes care of the company diversification to diversify away company risk. What we're left with is just pure stock selection, and that's what we're using to outperform the market.

Are all of the companies in the fund also in the S&P 400?

No, and I take pride in that. When people hear my process, they say it sounds like a closet benchmark fund. But most of my companies aren't even in the benchmark at all. And that's how you get the performance disparity. It's worked out relatively well—usually it has been positive performance

disparity, but I realize that there will be quarters when I'll trail the S&P 400 just because I don't look like it.

What kind of screens do you use for valuations?

In every different sector we use different valuation screens, so it's really company-, industry-, and sector-specific. For instance, we became very attracted to energy companies a couple of years ago because they were trading at their historical low in terms of price relative to enterprise value. We use enterprise value because many of these companies have a lot of debt, and the enterprise value takes that into account. For these companies you wouldn't want to use price-earnings ratios, especially at their cyclical lows, where they were two years ago, because they were all losing money.

To me, a valuation is much broader than simply a price-earnings ratio.

If you use only one measure, you tend to be drawn to certain industries and exclude others—for instance, low P/E screens will exclude technology. We don't want to get tripped up using hard parameters that exclude companies or good ideas from our investing universe—we try to be very inclusive, and we want to make sure that we are getting a reasonable trade-off between what we're getting and what we're paying.

Growth is a component in the valuation equation, and that's what we're trying to capture in our approach to building the portfolio.

It's a balancing process that requires more than just numbers, and I'm not a proponent of just relying on numbers. That's like having a good hunting dog but giving him the gun.

Within a sector, which companies do you choose?

When we were excited about the energy companies, we picked those we thought were going to be the specific big winners, and at the time we felt those would be the companies who were most leveraged to an upward movement in natural gas prices. One of my favorites, which I'm not in anymore because it had quite a move, was EOG Resources. The reason it was my favorite was because they didn't hedge their gas production. Some companies will sell their gas production into the forward markets and lock in a rate. I was very bullish on natural gas prices going up from $2 to $8 or $9 at one point in the cycle, and I wanted the company that was most leveraged to that natural gas move, which was EOG. Every 10-cent move in gas added 24 cents to their cash flow.

Now, with EOG Resources, it was very cheap, especially in that enterprise valuation, but there were micro-caps that were even cheaper and even more leveraged. In those situations, if the commodity price didn't go up, they had the threat of going out of business. But I felt very comfortable having met with EOG's management a couple of times, and they were one of the best management teams in this space. So that's a good example of what we viewed as a very good relationship between valuations, plus long-term growth and good short-term business dynamics.

But you don't view yourselves as GARP (growth at a reasonable price) investors?

My impression of the growth at a reasonable price managers is they're just looking for growth stocks that have gotten cheap for one reason or another. In my process, the trade-off between those three things allows me to go into such areas as basic materials, or REITs (real estate investment trusts), or chemicals and energy, areas that are usually not considered growth. In other words, I don't require a stock to have a 15% annual growth rate; if the valuation is very compelling, and the near-term dynamics are very compelling, I'm willing to sacrifice a little bit on the long-term growth. And the advantage of this process is that I think it makes the fund more sector diversified.

Are there any industries, for instance technology, that you have a hard time getting into based on your approach?

When the market became very overvalued, our process moved us away from technology companies, and you can see that helped my performance. With this pullback, the valuations have become more compelling and the fund is equally weighted to the benchmark.

But when valuations were high, we were still invested within the sector—I just looked for the stocks that had the better trade-offs, and that tended to lead us to the cheaper or laggard technology companies, not the high flyers that were everybody's favorites. They were experiencing somewhat similar growth rates, but they were just not the ones with the label on the product.

I've never been more than 10% underweighted in technology, because that's part of our process and it's important because sometimes the markets are going to continue to push those kinds of stocks up, and you want to have exposure to them. I don't want to just put my head in the sand and say 'I don't want to pay these valuations.'

And that brings up a point that's interesting in the current market—the role that interest rates play in terms of valuations. Interest rates play a role because you are willing to pay a certain amount for future earnings, and the amount you are willing to pay is a multiple of those future earnings, but their value today depends on interest rates. When interest rates are high, you should not pay as much for future earnings because those earnings are discounted at higher rates, and alternatively, you can invest at much higher risk-free rates. Conversely, when interest rates are lower, you can logically pay higher multiples for future earnings.

This is evident in the Graham & Dodd P/E matrix *(see accompanying sidebar*). On the vertical column, it has a low-risk bond yield, and across the top it has expected

five-year annual growth rates: 0%, 5%, 10%, 15%, and so on. The matrix displays what valuation you should pay in price-earnings ratio terms for any given stock, at a given growth rate and current interest rate.

This chart shows that as interest rates go down on your risk-free alternative, you need to pay more for any given dollar in earnings. And as that expected five-year growth rate goes up, you are willing to pay more. So, for example, for a company that is growing at a 10% annual rate in a 12% long-bond environment, you should only pay 10.5 times earnings—and that's what is remembered from those mid to late '80s when interest rates were very high and you had a great risk-free alternative. But as interest rates go down to 5% for a 10% grower, you should pay 25.1 times earnings. That's a pretty big jump.

So, when people today talk about everything being so overvalued, they're not taking into account the interest rate environment we're in now versus before. We've taken care of much of our inflation concerns in this country because of our great productivity growth, so we don't have to raise rates to head off inflation nearly as much as we used to. Obviously, we all remember the inflation we saw in the late '70s and early '80s—it was miserable, but it's a vastly different time in the market right now.

Why would you sell a stock?

I would sell if any of the three parts of the process

THE GRAHAM & DODD P/E MATRIX

Based on his observations of stock over the years, Benjamin Graham developed a stock valuation model that allows for future growth. Graham observed that the average no-growth stock sold at 8.5 times earnings, and that price-earnings ratios increased by twice the rate of earnings growth. This led to the earnings multiplier:

$$P/E = 8.5 + 2G$$

where G is the rate of earnings growth, stated as a percentage.

The original formulation was made at a time when there was very little inflation, and growth could be assumed to be real growth; the AAA corporate bond interest rate prevailing at the time was 4.4%. In later years, the formula was adjusted for higher current interest rates that contained an inflationary component:

$$P/E = [8.5 + 2G] \times 4.4/Y$$

where Y is the current yield on AAA corporate bonds.

As an example, at a 6% bond yield and an assumed annual earnings growth rate of 10%, the P/E multiplier would be:

$$\begin{aligned} P/E &= [8.5 + 2(10)] \times 4.4/6 \\ &= 28.5 \times 0.73 \\ &= 20.9 \end{aligned}$$

The Graham and Dodd P/E Matrix uses this valuation formula to show the price-earnings ratio that results from a given bond yield at a given rate of earnings growth. You can see from the table that changes in interest rates will have a dramatic effect on price-earnings ratios for any given earnings growth rate.

GRAHAM & DODD P/E MATRIX

Bond	Expected 5-Year Annual Growth Rate:								
Yield	0%	5%	10%	15%	20%	25%	30%	35%	40%
1%	37.4	81.4	125.4	169.4	213.4	257.4	301.4	345.1	389.4
2%	18.7	40.7	62.7	84.7	106.7	128.7	150.7	172.7	194.7
3%	12.5	27.1	41.8	56.5	71.1	85.8	100.5	115.1	129.8
4%	9.4	20.4	31.4	42.4	53.4	64.4	75.4	86.4	97.4
5%	7.5	16.3	25.1	33.9	42.7	51.5	60.3	69.1	77.9
6%	6.2	13.6	20.9	28.2	35.6	42.9	50.2	57.6	64.9
7%	5.3	11.6	17.9	24.2	30.5	36.8	43.1	49.3	55.6
8%	4.7	10.2	15.7	21.2	26.7	32.2	37.7	43.2	48.7
9%	4.2	9.0	13.9	18.8	23.7	28.6	33.5	38.4	43.3
10%	3.7	8.1	12.5	16.9	21.3	25.7	30.1	34.5	38.9
11%	3.4	7.4	11.4	15.4	19.4	23.4	27.4	31.4	35.4
12%	3.1	6.8	10.5	14.1	17.8	21.5	25.1	28.8	32.5
13%	2.9	6.3	9.6	13.0	16.4	19.8	23.2	26.6	30.0
14%	2.7	5.8	9.0	12.1	15.2	18.4	21.5	24.7	27.8
15%	2.5	5.4	8.4	11.3	14.2	17.2	20.1	23.0	26.0
16%	2.3	5.1	7.8	10.6	13.3	16.1	18.8	21.6	24.3
17%	2.2	4.8	7.4	10.0	12.6	15.1	17.7	20.3	22.9
18%	2.1	4.5	7.0	9.4	11.9	14.3	16.7	19.2	21.6
19%	2.0	4.3	6.6	8.9	11.2	13.5	15.9	18.2	20.5
20%	1.9	4.1	6.3	8.5	10.7	12.9	15.1	17.3	19.5

deteriorates. So if the valuation becomes less compelling, long-term growth somehow changes, or the near-term dynamics turn very negative and I don't think that's fully reflected in the stock price yet, I will sell.

I don't set price targets and say that if a stock is going to go down by a certain factor, I'll sell. It is more a function of what my new ideas are, what's going on in the market, how the stock is performing versus its peers, how much exposure I have to that industry—I don't want to be overexposed to any industry, and so on. There are a million things that go into it.

When a stock is not doing well, what is the thing that normally will flag that to you?

Probably the near-term business dynamics. You'll start to hear the people following the stock say they're having a little bit of trouble this quarter. Anytime a company is having trouble today, that's your best indication as far as how they're going to do tomorrow.

The portfolio turnover rate is very, very high. How long do you typically hold onto a stock?

We do tend to have higher turnover, but there is one year in which our rate is misleading because at the time the fund was very small, and any cash flow in or out caused big swings.

This last calendar year, the turnover rate was about 200%. To be honest, 200% is still high, but I think that that will continue. I like to sell and trim positions into strengths and add them into weakness, even if nothing in the story of the firm has changed, so that in itself creates turnover.

For instance, last year when we were excited about energy companies, we were overweighted versus the benchmark, but by the beginning of this year, everybody started catching onto the energy story, and the prices were way up, so we trimmed. More recently, the energy stocks came back down again, and I recently just bought again and added a little more, so now I'm overweighted again.

What I do, though, is to try to offset capital gains for individuals, and I think I've done a pretty good job of this, especially lately. That also adds to turnover, but I think it's the best way to build aftertax returns.

Your performance in the past couple of years has been tremendous. To what do you attribute that?

Our stock selection process drives me into certain industries, so when you do an attribution analysis of my fund, a lot of it appears to be sector weightings, even though we do limit the amount of over- and underweightings. But I would say the only reason I was overweight—for instance, energy—is because I found a bunch of companies I liked in energy, so it was stock selection. But I'm not trying to find a sector to overweight. I find stocks company by company until it turns out that that's what we're weighted.

But by and large, this fund has had the luxury of being up over 20% in each of the last three years because we are diversified, based on a broad benchmark, and I don't zero out any areas like technology.

How do you measure risk in the fund? Is that something you analyze separately, or is it inherent within your investment philosophy?

It's inherent in the philosophy. We are diversified by sector, by company, and we try to make sure we aren't running to cash and trying to time the market—things like that take care of the kinds of risks we want to eliminate.

The risk of picking the wrong stock—I'm willing to shoulder that. ✥