A SEARCH FOR THE BLUE CHIPS: DURABLE, SUSTAINABLE EARNINGS GROWTH

FUND FACTS

T. ROWE PRICE BLUE CHIP GROWTH (TRBCX)

CATEGORY:
Growth

PERFORMANCE: (thru 9/30/00)

Compound Annual Return (%)	Fund	Category
1 Year	25.8	23.7
3 Years	19.7	13.1
5 Years	23.3	18.2

RISK:
Below Average

TOTAL ASSETS: (as of 9/30/00)
$8 billion

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The year 2000 has not been kind to the markets. As of the third quarter, the S&P 500 was down 1.3%—quite a comedown from the lofty returns of the prior few years.

But not all market sectors have fared so poorly and, in fact, the market most recently has rewarded lower-risk mutual funds while penalizing some of the recent high-flying sectors.

One lower-risk growth fund that has fared well recently, and over the longer term, is the T. Rowe Price Blue Chip Growth fund. The fund returned 7.9% for the first three quarters, compared to 6.6% for the average growth fund, and it has been among the top 20% of all growth funds for the three- and five-year periods ending September 30. Currently, the fund has about $8 billion in total assets.

In early October, fund manager Larry Puglia discussed the management of the fund with Maria Crawford Scott.

What is the investment philosophy of the Blue Chip Growth Fund?

When we launched the fund back in 1993, there was considerable discussion here about what constituted a "blue chip growth" company. Some people felt we should own the old Dow Jones smokestack companies; others said we needed to own the Ciscos and the Microsofts.

After giving it a lot of thought, we decided that it was durable, sustainable earnings per share growth that confers blue chip status on a company. That's what allows it to garner an above-average price-earnings ratio, and that's what allows you to really hold such an investment for the long term and allows your wealth to compound.

So that's basically what we're trying to do—we're trying to find companies with durable, sustainable earnings per share growth, and we want to hold those companies for the long term.

What criteria do you look for in a company to produce durable and sustained growth?

There are really three things that we focus on. The first is a leading market position, because it confers not only cost advantages but also pricing advantages. In other words, if a company has superior market share, they have not only learned to make their product more cheaply, but they also have more pricing flexibility in the marketplace.

The second thing we look for is seasoned management. That sounds trite, but what we're really getting at is management that has demonstrated over a long period, as Sanford Weill has done at Citigroup, that they can do several very important things: one is to allocate capital to the highest-return businesses and pare away low-returning businesses; and two is to be able to manage expenses aggressively. Those two things are quite important because many of the companies we're investing in are multinational companies, so they're much more complex to run than a solely domestic company, and they're also companies that are maturing to a certain extent.

The third thing we look for is strong financial fundamentals. For this, we look at a number of different ratios, but the most important by far is above-average earnings per share growth, and whether or not we think it will persist. By that we mean that we'd rather own a company that has been growing earnings at 20% that we think will be a consistent 20% in the

future, rather than a company that might grow 30%, but we fear may blow up and not continue to grow at all.

The other financial fundamental that's quite important to us is return on equity, or some other measure of return, such as cash on cash returns or return on net assets.

To come up with a list of blue chip stocks, do you screen based on historical earnings growth?

Yes, but we're also looking at projected earnings per share growth and we're looking at projected returns. I think the most important thing to understand is that we don't screen a bunch of companies and then buy the ones with the highest returns. Screening would really be the starting point for us, and then we look at a number of qualitative factors. For instance, we'll visit the company to assess the quality of the assets and the integrity of management; we'll talk to competitors, suppliers, and customers to verify that certain businesses are performing as we think they are performing. We don't have a purely numbers-driven approach.

What's your definition of growth—is it relative to the market, or relative to a firm's industry?

We're looking for growth that's very strong relative to a firm's industry, but it has to be sustainable. Generally, we're looking for companies with 15% or greater long-term growth. Now there are exceptions—for instance, Fannie Mae. We think that Fannie Mae's long-term growth rate is probably 13% or 14%, but it's very attractive relative to the other companies in its particular industry relative to the risk of variability of its earnings stream.

Are most of your blue chip firms S&P 500 companies?

A good many are, but our returns can vary quite a bit from the S&P 500 from time to time. We have had certain periods—this year being an example—where we've been substantially ahead of the S&P 500.

Perhaps because you are focusing on the growth companies?

To a certain degree, but this year we've been overweighted in financial stocks, for example, which has helped us. Even in the technology area, our stock selection has helped us. Not owning Lucent for the last month or so helped us. Lucent is quite a big holding in the S&P 500. We owned a little bit of it and then had sold it. Coca-Cola is a name that we have underweighted for several years, and now we've moved back into it, and it has had very good strength.

What about valuations? Do you have a list of companies that you're interested in and then wait for valuations to come to a certain level, or are valuations taken into consideration when you're actually looking at the company in the first place?

Both. Stock candidates don't make it onto our list unless they have a valuation that's not too far away from a buy point. In other words, if we see a stock we think is 40% overvalued, it's probably not going to make it onto our watch list, although we may continue to monitor it.

What we try to have on our watch list are companies that we really want to own due to their fundamental characteristics, but where we may need more facts. By that I mean that there are times when a stock is very compellingly valued, but we have questions about an upcoming quarter or about certain aspects of their business. Then there are also times when a stock may be 20% overvalued where we can find nothing wrong with the business; we'd love to buy the stock, but we are just waiting for it to come back in value. But not every stock on our watch list is an overvalued one that we're waiting to come down. Some have very compelling valuations, but there is some other aspect of the fundamentals that troubles us.

How do you value a stock?

There are a couple of different methods we use, but primarily we rely on relative price-earnings ratios based on where we think a stock ought to trade one year out. I'll use Coca-Cola as an example. Say Coca-Cola trades at about 30 times what we think they'll earn in 2001. That's about a 20% premium to the market based on its historical average, and that's an attractive premium if all the qualitative factors are in place.

We do look at other valuation methods as well—for instance, we'll look at discounted cash flow valuations, in which we'll take into account five or even 10 years of cash flow data. We do that as a double-check on many companies.

But valuation is not the primary criteria for inclusion in the fund, although it is one criteria.

Do you require companies in the fund to pay dividends?

No, we think that share buybacks are a more tax-efficient way of returning capital to the shareholders. We also are cognizant of the fact that if you want to buy high-quality growth companies, they often don't pay dividends.

What about industry diversification? Do you tend to be primarily in growth industries?

Yes, but it's our definition of growth industries. And that's why, even when we do own stocks in, for instance, the financial industry, we own more of things like State Street Bank, Bank of New York, Citigroup, Fannie Mae, and Freddie Mac. We think Citigroup, having grown earnings at over a 20% compounded rate for the last eight or 10 years, is certainly a growth company and probably the preeminent growth company in the financial services group. And we think the financial services area is

a growth area.

We think that health care is a growth area. We think that technology is a growth area, and we hold as much in technology as the S&P 500. Our largest holding right now is Pfizer, which I think most people would consider a growth company, although it trades at 33 times what they'll earn next year.

We think that one of the opportunities in the market derives from the Internet craze. A lot of companies, using Safeway and State Street as an example, were very depressed because they were viewed as old economy companies. Now we see State Street making a new 52-week high—it's come all the way back from $30 a share. People are starting to realize that Safeway is very well-positioned to deliver strong earnings per share growth. We certainly view Safeway, State Street, and Citigroup, as well as Cisco, Northern Telecom, and Sun Microsystems, as all good growth companies.

So you'll invest in stocks that are growing in areas that aren't necessarily considered growth industries?

Yes, but part of the fallacy is that, taking Safeway as an example, the supermarket industry is viewed as a slower-growth industry, or taking State Street as an example, the financial services industry is viewed as slower-growth. In fact, both areas have supported very solid double-digit earnings growth for years. We are even willing to look in the energy industry for growth. We have a good position in Exxon Mobil, because regardless of what's happened to energy prices, Exxon Mobil has produced strong double-digit earnings per share growth over a long period of time, and it's one of the most financially strong companies around.

We are willing to own those kinds of companies, but we're also willing to own well-known growth, like Oracle, which has produced very, very strong top-line growth. We don't think it's an either/or position.

What about Internet stocks?

We own Internet stocks that we think can and are producing, or have the prospects to be soon producing, strong double-digit earnings per share growth. For example, we have AOL.

Here again, the thing that we require of all of our companies is that they have very good prospects for earnings growth. That doesn't mean that we don't own any firms that don't have earnings—we own a few—but they're going to be profitable very shortly. For instance, Ariba is the leader in business-to-business software, and it is probably the biggest holding we have where there's not a lot of earnings underneath the company right now.

What gives you confidence that they will have earnings sustainability soon?

There are several powerful things about the company. They very quickly established themselves as a leader in the business-to-business software and commerce area, which we think is going to be a huge growth area for a long period of time. But the more important thing is that if you look at the backlog that they already have in the business, they're already profitable from an economic perspective. They're not reporting earnings yet because the accounting is so conservative. The business is intrinsically profitable—it has a very high gross profit margin, as many software businesses do. And they are well-aligned with all the meaningful companies—for instance IBM—to allow them to produce superior growth.

The fund's portfolio turnover is pretty low. How long do you typically hold onto a stock, and what would prompt you to sell a stock?

Generally, we buy with the hope that we can hold a stock indefinitely. From a practical standpoint, we've had turnover of roughly 25% a year. What causes us to sell is when there is a meaningful deterioration in the fundamentals. That can include a change in management, a strategy that's found to be flawed in terms of how the business is conducted, a significant change in the customer base, short falls in profitability—that kind of thing.

A good example is Kodak. That's a sale we made awhile back and it is a very timely example because just today Kodak was way down, and it dragged the Dow Jones industrials down pretty significantly. We sold it because we felt we saw deteriorating fundamentals. For instance, the free cash flow in the most recently reported quarter—and this would be one quarter back when we were looking at it—we thought it was rather lackluster, and that there was excess inventory in the channel. Those would be shorter-term concerns, and then there were longer-term concerns. We felt like they weren't really demonstrating the development of products they would need to have to really drive the growth in the company.

Would you sell a stock if it became so overvalued that you became uncomfortable holding it?

Yes. We did that with AOL before. Based on our valuation models, we couldn't produce cash flow or earnings estimates that would support the stock price—even if we used fairly aggressive assumptions.

Would there be any reason that you would restructure the portfolio and move to more defensive positions?

We don't think of it in that way. One of the biggest mistakes you can make in investing is to sell your winners, and you sell all your winners if you sell all your high-quality companies—the companies that have produced solid results. Then you don't have a blue chip growth fund any more.

Are we willing to buy more of a conservative growth company if we feel the market is going to be choppy? Yes, but we're going to remain in growth. ✥