SEEKING GOOD BUSINESSES AT GOOD VALUES AMONG THE SMALL CAPS

FUND FACTS

NEUBERGER BERMAN GENESIS FUND (NBGNX)

CATEGORY:
Growth

PERFORMANCE: (thru 3/31/01)

	Fund	Category
Compound Annual Return (%)		
1 year	19.2	–8.4
3 years	6.6	3.6
5 years	15.6	12.4

RISK
Below Average

TOTAL ASSETS: (as of 3/31/01)
$2.4 billion

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In 2001, less is more for most stock funds, at least as far as performance is concerned. The question isn't 'who's up more?' but rather 'who's down less?'

Not all funds, of course, have suffered, and the common thread among many funds that have eked out positive performance numbers during 2001 is a value-based approach.

One fund that has done well using a value approach both recently as well as longer term, is the Neuberger Berman Genesis Fund, which focuses on smaller-capitalization stocks. The fund was among the top 20% of all growth stocks for the first quarter of 2001, as well as the one- and five-year periods ending March 31. The fund has about $2.4 billion in total assets.

In early May, portfolio manager Robert D'Alelio discussed the management of the fund with Maria Crawford Scott.

What is the basic investment approach used by the fund?

We are small-cap value managers. Generally speaking, we are dealing in companies that are less than $1.5 billion in market capitalization.

As value managers, we look at traditional measures, such as low price-earnings ratios and low prices relative to cash flow. But we have a very strong quality focus. We're not 'deep-value' managers—we're not interested in stocks that are merely cheap, but rather we're looking for good businesses that happen to be cheap, and we think that's an important distinction.

If you look at the small-cap market, you'll find a strong bias toward growth investing—managers who are looking for the next Microsoft or Wal-Mart while it's a little company. Generally, they're looking for growth rates greater than 20%. But the U.S. economy isn't growing anything like that, so they are focusing their assets on a very small, handful of industries. And they leave everything else behind. So in the small-cap market, because of this style bias, it's actually possible to buy good businesses—perhaps in mundane industries but consistently growing at a mid-teen rate, with good balance sheets, good cash flow generation and all those kinds of things—and still pay value prices for them.

What's the first thing you look for?

We like businesses that are profitable, and we measure that based on return on assets. We like return on assets because it levels the playing field, whereas return on equity is influenced by financial leverage.

We look for superior returns on assets, which for us is about 8%. To put that into perspective, the Standard and Poor's 500 return on assets over the last five years is about 5% or 6%.

We also look at a company's free cash flow. We look at the company's recurring sources of cash, mostly net income and depreciation and amortization, and we look at their on-going uses, typically capital spending and their working capital requirements, to determine whether the company is throwing off free cash. And then we try to determine the rate at which the company is capable of growing long-term.

Basically, we're trying to determine the sustainable growth of the business. There are lots of companies that can grow at a very rapid rate, but they can't finance a continuation of it, so they have to be selling stock constantly. That's a dangerous game, especially in the markets we've seen recently—for instance, the market has shut down financing to some of these Internet stocks.

And there are conflicts of interest on the sell side of Wall Street. If a com-

pany needs to issue equity, they have to do an initial public offering or a secondary offering, and Wall Street makes an awful lot of money from that. So those are the companies Wall Street analysts tend to cover. Their coverage of companies that generate a lot of cash and can self-finance their own business is actually pretty modest—not because the business isn't attractive, but because they don't think they can make a lot of money doing the underwriting. That's fine with us—we think they are leaving behind some very good businesses. So we place a lot of emphasis on free cash flow.

One other thing we look closely at is the barriers to entry into the business. We're basically looking for superior profitability, and in a competitive world, those superior profits will be competed away unless you have some type of barrier in your business. And those can be pretty subtle.

For instance, currently our largest holding is a company called AptarGroup. They make pumps, valves, dispensing systems, and closures that go into household products and cosmetics, and they are involved in the food market, fragrances, and the pharmaceutical market. One barrier to entry in their business is, first of all, they have innovative products that are patented. But the real barrier to Aptar's business is that about one-third of their business is in the pharmaceutical market, where they make sprayers for nasally inhaled drugs. There, you have to go through the FDA approval process with whomever the vendor is, and that's a super-high barrier. The dispensing system has to deliver a very precise dose, and it can't react with the drug it's containing. So you can think of their fastest growing business—the pharmaceutical/drug-delivery market—as having the same barrier to entry as you would a pharmaceutical business.

The other major factor we look for in a prospective company is some reasonably good growth rate. Typically, the portfolio in the aggregate is growing at a normalized rate of about 15% a year, although it would be better than that in a stronger economy, and a little weaker than that in a weak economy.

Once you've found these characteristics in a company, how do you determine whether the stock is selling at a reasonable value?

Generally, we're interested in businesses that are selling at a discount to the market overall, to start with. We're trying to build a diversified portfolio of stocks that are superior to the market in terms of their growth, profitability, balance sheet, and cash generation, but that are selling at a discount.

Do you make adjustments based on growth rates?

Yes, it's a trade-off, although we're generally not interested in businesses that aren't growing or are growing only modestly. But let me just give you an example of how some of these things tie together.

One of our holdings is Newport News Shipbuilding. They have tremendous predictability in earnings, but they probably only have 3% to 5% revenue growth. However, they generate tremendous excess cash flow—way beyond what they need to fund that kind of growth. The amount of cash they would generate when we were initially buying the stock was equal to 10% or more of the value of the total company.

What can they do with that? Well, what they chose to do with that was to buy back the stock. So, here's a company that on the surface looks like it's growing 3% to 5%—pretty unexciting—but if you understand the cash flow of the company, you can see how they throw off so much cash that they can actually grow at probably 12% to 15%, because they're using that free cash flow to buy back their stock every year. And in 10 years, they'll be private if they want to stay on that pace. It turns out, however, General Dynamics is going to buy them before that happens. But this is an example of a business that, on the surface, looks to be growing slowly, but when you analyze the cash flow you can see it's actually growing at a higher rate.

Does your approach tend to result in concentration in particular industries?

I think every manager has some industry bias. We try to minimize it. There are some value managers that will not own technology; we are not one of those, although we do require our technology companies to meet the factors I mentioned earlier. We try to stay as diversified as we can. We're willing to make some bets on industries. But we do want to run a diversified portfolio and have exposure to most industries, as long as we can find businesses that fit our criteria.

We tend not to look at the SIC industry categories or the way S&P categorizes companies. Instead, we like to group businesses into clumps of companies that act similarly. So, for instance, we have a category that we call "steady Eddie"—mostly consumer staples, although not exclusively.

AptarGroup, for example, is a "packaging" company, but I think it has very little in common with most traditional packaging companies, which tend to be low-growth cyclicals. Aptar has had up earnings for 29 out of 30 years, and up revenues for 30 out of the last 30 years. It's a steady-Eddie in our view.

How do technology stocks fit into the fund?

I'll give an example of how we invest in tech. We own a company called Black Box, which is really a service provider. It started out with a phone-based service and a huge catalog. They sell all the little widgits that you need to hook up your network locally, which they supply on a very timely basis because you don't want your system down or your computer not working just because you don't have this little part.

The company's core business was basically a play on the proliferation of technology. It didn't matter whether

you bought a Sun server, or an Intel PC, or whatever, you just needed this service in order to hook up. And they've gone from this phone-based service to an on-site service where they can actually pull cable inside a building.

The point is, it's a service-based business, it generates a ton of cash, they've grown the earnings at probably 20% a year plus for a long, long period of time. They've self-financed the growth because they don't need the capital because they throw off a lot of cash. It is simply a really nice business. And we don't care whose technology wins here.

That's how we like to play tech, because you can get destroyed by somebody in a garage obsoleting you, and you don't even know it until it is too late. Did Black Box stock keep up with Amazon? No, but at least it went up when Amazon was going up, and it went down some when Amazon went down—and I'm just using Amazon as an example—but it wasn't as extreme.

How does your industry breakdown compare to the Russell 2000?

At the end of the first quarter, our biggest weighting was in financial services, at around 22%—pretty close to the Russell 2000. Our next biggest weighting is in energy at about 13½%, which is quite a bit more than the Russell, which has it at about 4½%. Our next biggest weighting would be technology at about 12% versus the Russell's 9%.

Do you pay much attention to non-financial characteristics—for instance, the managers?

Management is very important, and we spend a lot of time looking at it.

We also spend a lot of time looking at the proxy, trying to understand management financial incentives. We look for incentives that match up with things that make sense to us. For instance, we are long-term investors. Some investors get very excited about stock price-based incentives—you know, 'if the stock price isn't there, they don't get paid.' We get a little nervous about those kinds of incentives because it can cause management to do things short-term that aren't necessarily in the best long-term interests of the company. We like management goals that take the whole picture into consideration.

What would prompt you to sell a stock?

There are a series of things that would cause us to sell a stock. Broadly speaking, the good sale would be because the valuation got to be too high, where it is selling at a premium to the market—at that point, we would begin to scale out of our position.

Sometimes we'll make a relative trade-off—the company might be okay, but there's another company that's actually better, growing faster, has a better profile, and is the same price or cheaper.

We would also sell if we felt we had made a fundamental mistake. We're in a batting-average business and we fully expect that some of our holdings aren't going to turn out the way we thought they would. In that situation, you try to recognize your mistake as early as you can. What I would say is that, because we are buying quality companies with decent balance sheets and strong cash flow, when we do make mistakes, they tend not to be fatal, and we have time to adjust.

Are there any warning signs you look for that would tell you you've made a mistake?

Usually the stock price tells you pretty quickly.

I wish there were a typical mistake and then we could correct it forever, but there really isn't. Sometimes you find out that the barrier you thought was there wasn't as strong as you thought, or someone found a way around it. It's all over the lot.

Generally, though, the big issue in this area of the market is that you often have a management team that is entrepreneurial—they started the company, and they're good enough to get you from X millions to hundreds of millions of dollars in revenues. However, many times they are not the people that can take you to the next level, but they still own a lot of the stock and they're still trying to run the company.

Your fund has done quite well for a value fund over the long term, but there are some very difficult years for all value managers. Was it tough to stick with your approach?

It was a pretty painful period. When you're in that kind of an environment, sometimes you think you are going crazy—maybe you're missing something or maybe you should just run out and buy some Internet stocks because that's the way the world's going. But I've seen enough markets to know better than that. So we stuck to our guns. Eventually, the elastic band only gets pulled so far before it snaps.

And we did own some technology. We weren't tearing up the pavement, for sure, but it could have been a lot worse. So, we have always had at least some exposure to technology. And it was that diversity that made a very tough situation fairly tolerable.

I think it is important to realize that, if you're a value manager, you can always buy good companies—not broken down, hurting, dog-companies, but very good businesses. They're just not sexy enough to get the attention of most of the growth managers, and they're not generating enough of the underwriting fees for Wall Street analysts to care about. It is a very inefficient market.

The flip side of all of that is that you actually have to do the work yourself. There's tremendous opportunity, but it requires effort, and we're expending that effort. ❖