A SECTOR-NEUTRAL APPROACH TO PICKING LARGE-CAP GROWTH STOCKS

FUND FACTS

TURNER GROWTH EQUITY FUND—(TRGEX)

CATEGORY:
Growth

PERFORMANCE: (thru 6/30/99)

Compound Annual Return (%)	Fund	Category
1 Year	27.1	13.9
3 Years	28.5	20.8
5 Years	26.5	21.2

RISK: (relative to category)
High

TOTAL ASSETS: (as of 9/1/99)
$154 million

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Except for the most recent quarter, large-cap and mid-cap growth has been where the market action is. In the last year alone (through the end of June), large-cap funds returned 17.9% and mid-cap funds 27.7%, compared to only 3.8% for the small-cap funds. Meanwhile, growth funds beat value funds by a score of 23.4% to 6.3%.

One fund that has benefited from this trend, and has beaten all but one of the style averages, is the Turner Growth Equity Fund, which focuses on large- and mid-cap growth stocks. Turner Growth has also managed to outperform its category peers—it is among the top 20% of all funds in the growth category for the last year, last three years, and last five years (through the end of June).

Currently, the fund has $154 million in total assets.

In early September, Robert E. Turner discussed the management of the fund with Maria Crawford Scott.

What is the investment objective and philosophy of the fund?

As the name implies, we are a growth fund. The philosophy behind the approach is that earnings expectations drive stock prices. We focus on buying the stocks with favorable earnings dynamics, and we immediately sell those with deteriorating earnings.

Part of the philosophy, too, is a fully-invested, sector-neutral approach. We don't believe we can time the market, and therefore we never raise cash in the portfolio. And our sector-neutral approach is, I think, unique among growth managers. This portfolio is sector-neutral to the Russell 1000 growth index. For example, if technology currently is 36½% of that index, that's where our exposure is; if healthcare is 18¼%, we are at 18¼%. The view behind that is that we believe our true strength is stock selection, and not any ability to time the market or market sectors.

And you use the Russell 1000 growth index as a comparison measure?

Yes. We recognize that over time we'll have to outperform the market, which is the S&P 500, but as a growth manager, for the most part, we are held more accountable to the growth index. That index will have more technology, healthcare, and consumer-type companies, and less financial, energy, and some of the cyclical sectors than the S&P 500.

So, although you are sector-neutral with respect to the growth index, you are still within the growth sector of the market?

Yes, and even though we are sector neutral, that doesn't mean that we are industry-neutral. I am being somewhat definitional here, but, for example, in that 36½% in technology, we have an overweighting in communications equipment and semiconductors, and less in software at this point.

Do you only hold companies that are in the Russell 1000 growth index?

No, we will own some outside. I would say about 80% of our holdings are within the Russell 1000 growth index.

Also, our holdings are large-cap or mid-cap, although the large-caps predominate—it is roughly 75%/25%.

How do you make your selections?

We look at three criteria. First, we do a modeling process—a quantitative

ranking. Second, we apply fundamental research. And third, we look at the technical pattern of the stock. Among the three, the fundamental research by far is the greatest focus.

What are the quantitative rankings based on?

It is really a discipline we use to deal with a fairly large universe of stocks. We've identified factors that are predictive of each of the 10 broad sectors that we analyze. What is unique to our ranking process is that we rank by size and we rank by sector. So, for example, we're ranking large-cap pharmaceutical stocks versus other large-cap pharmaceutical stocks. We then focus on the top-ranked stocks within each of those 10 sectors.

And your decisions there are primarily based on earnings growth?

Yes—earnings-related, whether it is earnings surprises, earnings revisions, the price-earnings ratio relative to the growth rate, how many analysts are raising their estimates versus how many are lowering it, etc. We will take a look at a variety of factors and try to find those that are most predictive.

When you look at analysts' estimates, what do you find is useful? Are you looking for consensus estimates that you go along with, or do you want to go against the consensus?

Our view is that the consensus estimate for a stock is reflected in the current stock price. As analysts, we are really coming in and trying to make a determination as to whether that consensus is correct or will be changing. So, for example, if we feel a company will announce earnings above expectations, we'll certainly feel comfortable either holding it or adding to the position.

Are valuations included within the quantitative analysis?

Yes. We do look at valuations, and sometimes what happens is that a company may continue to have pretty good earnings prospects but the stock's just run up a lot in price. In that case, we either will scale back or sell the stock entirely, but that doesn't mean that there is a potential disappointment in earnings, it just means that the price got ahead of earnings.

What would be a high valuation for you?

It is all relative. I guess it is a high valuation when the earnings stop exceeding expectations and start coming in line more at expectations. We do look at the price-earnings ratio relative to the growth rate, and all things equal, we prefer to have a company that is trading at a lower price-earnings ratio than its growth rate, but that doesn't happen that much anymore. At the same time, we acknowledge that a company like Microsoft can trade at a higher price-earnings ratio than its growth rate based on the sustainability of all of its sources of earnings, versus a smaller software company that just has one product that is less predictable and maybe more dependent on one line of business. As I said, it truly is relative, but we really do want to make sure that the earnings continue to beat or exceed expectations.

You said you spend most of the time on fundamental research. What kinds of things are you looking for?

First of all, we want a solid understanding of the trends within the industry.

I'm going to comment more on technology because that is the area I cover specifically. But as an example, currently we are overweighting telecommunications equipment, and the reason is my general understanding that there is going to be a grab for bandwidth. Companies are going to compete with the long-distance carriers, they are going to compete with these competitive local exchange carriers, like Nextel, and they are going to compete with the fiber companies like Quest Net and Level 3 Communications. The thing that is common in all that competition is that each of them is going to have to have the best, the fastest and most efficient equipment, and therefore, there will be beneficiaries in the telecommunications equipment area.

The real key is having a good sense of the industry and what's happening, and then being able to make selection decisions on that basis.

You mentioned that you do a little bit of technical analysis. What are you looking for there?

We really use the technical work as an early warning indicator. So, for example, if the technical pattern begins to deteriorate, as analysts we begin to focus more intently on that stock. There may be nothing that we can see fundamentally, but something technically is telling you that there may be problems. We rarely sell stocks solely on the technical pattern, but it's a reason to focus our efforts.

We use relative strength, moving averages, we look at money flow variants—that is probably our primary focus. Is there accumulation or distribution? Are people buying the stock on volume? Are they willing to pay the high price for the day or are they selling it aggressively?

On the buy side, we use it as a confirming indicator. If we have identified a stock through our ranking process and it has good fundamentals, it is also nice to have the technical pattern confirm that we are making the right decision.

Do you invest much in Internet stocks?

We prefer to go into some of the companies that indirectly benefit from technology and, particularly, the Internet. We don't currently own Federal Express because it has run up quite a bit in price and we are now on the sidelines, but that is one past example. The reason we felt

it would benefit indirectly from the Internet is the need for Internet companies to get their orders to their customers as quickly as possible. It will be interesting to see, as UPS is coming public, how that begins to trade.

Also, there are a lot of telecommunications companies that are supplying all the equipment to the Internet companies, so that's another way we've tried to play it.

What about growth companies that aren't really connected with technology? Are there very many of those left?

Yes, there are. By being sector-neutral, we have to look at each area. In the consumer discretion area, the better growth stocks there are probably some of the media companies. And you could almost argue that they are Internet related because at some point their content gets on the Internet. We own CBS, Clear Channel and Time Warner. Certainly, some of the large retailers are still growth companies—Wal-Mart, Home Depot, and Costco, but they have all developed their Internet strategies, too.

The consumer staple area is 10¾% of the Russell 1000 growth index, and these are the traditional food and beverage companies. This has been a tough area in general because these companies have not had much of an ability to raise prices, so it's been a harder area for us to find good growth names. But we like Procter & Gamble and Colgate, whose situations are improving based on the improving global markets. Quaker Oats has done OK based on their Gatorade sales, but beyond that it is hard to find a lot of good growth names.

What would cause you to sell a stock?

We would sell at the first sign of earnings concern. That first sign could be any number of things. The worst sign is a company saying that they are going to miss their earnings target. Hopefully, we won't have waited around for that to happen, because at that point the stock will go down a lot.

Another warning sign may be an overall concern with the industry—retail sales are going to slow because of consumer confidence going down, or maybe teenage apparel is not going to do well relative to another sort of apparel, something like that. Or it may be company specific—one company is just not having good same-store sales compared to previously.

By having our analysts focus on sectors, combined with our concern with earnings, chances are we're going to uncover changes and react very quickly to sell the stock. And by virtue of being fully invested and sector-neutral, even if we make the wrong decision when we sell the stock, most likely we'll replace it with another one that will go up just as much, if not more.

So, we have our finger on the trigger and we're willing to exit quickly even if we're wrong, because we can find something else that will do just as well. As a result, we tend to get out prior to something bad developing.

Your fund has done particularly well with its focus on the mid- and large-caps, and they have done well in part because that is the area that has most benefited from the technology boom. Why has that boom bypassed the smaller-caps?

Small-caps have probably caught up a little bit there, as the market has broadened out somewhat. But in technology, you really don't want to be a small-cap company very long because that means the big guys are going to come after you very fiercely. You really do have to move to the mid-cap status very quickly. Typically the small-cap tech companies are one-product firms, and if they experience much success, the bigger companies are going to come into their space. If that means substantial price reductions on a competitive product, it may not hurt the big companies at all, whereas for a small company you could be in big trouble. I would say that is the reason that mid-size and large stocks tend to do better in the technology area—they are more diversified and more able to move in and exploit new markets very quickly.

People always argue over growth versus value stocks and which type will dominate in terms of performance over the coming years. Currently, it has been growth stocks. What is your outlook for growth stocks?

We think growth stocks will continue to shine and our view is that we are in a long-term secular change where growth stocks will continue to perform well for several reasons.

First, the largest and fastest-growing segment of the economy is technology. Technology is growing at 15% to 20% per year. In 1990, technology stocks made up 9% of the S&P 500. They currently make up 20%, and because of their growth, that number will go to 30% or 40% over time.

Second, you have a tax law favoring growth stocks. Capital gains are taxed at a cheaper rate than dividend income.

Also, we feel that the market is just becoming more growth-oriented. You do have periods like we had in April through July of this year where value stocks did so well because the economy picked up and interest rates went up. When interest rates go up, the value stocks do better because the perception is that the economy is getting stronger, so their earnings are going to be better. At the same time, the growth stocks, which have higher price-earnings ratios, see those ratios contract when interest rates go up because future earnings are worth less when you discount them back to a present value.

You will have the periods as we've had where value comes back into favor on a near-term basis. But certainly our viewpoint is, without a doubt, growth stocks will be the place to be and large-cap growth stocks will do very well in that environment. ✦