Susan Byrne, portfolio manager, Westwood Equity Fund

Exploiting Wall Street's Mistakes: A Search for Unexpected Growth

Seeking "mis-priced" stocks is a fairly common goal among investors. But there are many different methods of finding and exploiting these market "mistakes."

One interesting approach is used by Susan Byrne, portfolio manager of the Westwood Equity Fund. She focuses on the earnings estimates of Wall Street analysts, and purchases firms that are growing faster than currently perceived. Positive earnings "surprises"—reported earnings greater than expected by most analysts—are used to confirm her picks, and to help flag potential firms for further analysis.

The approach has served the fund well over the long term, with performance among the top 20% in its category for the last three and five years for the period through September 30. Its total return over the last three years was 30.6% annually compared to 25.1% for the average growth fund, and 29.8% for the S&P 500; for the last five years it returned 23.9% compared to 19.5% for the average growth fund and 20.7% for the S&P 500. In the last year it returned 39.6% compared to 35.2% for the average growth fund and 40.4% for the S&P 500.

The fund currently has about $140 million in total assets.

In early October, Susan Byrne discussed the management of the fund with Maria Crawford Scott.

What is the basic investment objective of the fund?

It's an equity fund whose mission is to perform well in good markets and perform very well in poor markets. We accomplish that by seeking growth that will be greater than the S&P 500, while paying less than the S&P 500, and combining that with a bit higher dividend yields. So we are primarily seeking good risk-adjusted returns.

You mentioned higher dividend yields—is dividend income an objective?

The primary mission of the fund is capital appreciation; income is a secondary consideration. But to control the risk and volatility of the portfolio, I'll use different higher-yielding instruments to keep it from jumping all over the place.

What area of the market is your main focus?

I would put us more in the mid to large range in terms of market capitalizations. We own some of the very largest companies, and we own some companies that are right at $1 billion. It's not too often that we're going to have a lot of small-cap names.

What's the primary criteria for selection?

We're looking for unrecognized or unexpected growth. We accomplish that by doing our own fundamental research on individual companies, and the kinds of companies that would make it into our portfolio are those that we think will have future growth rates that will be greater than the rates expected by Wall Street, as measured by firms such as Zacks Research, which report on analysts' earnings estimates. So, we're looking to own companies that are growing faster than currently perceived, and we use earnings surprise models to confirm that we're on the right track.

Each stock in our portfolio is equally weighted and each is about 2.5% of the portfolio, so we don't have hundreds of names in the portfolio—each one we own is what we consider to be the best, and we own each one offensively. As confirmation that we are on the right track, we would expect our companies to report earnings surprises, meaning "up" surprises (higher-than-expected earnings), not "down" surprises.

That's our methodology, and it can lead us into companies that some people think of as traditionally growth and sometimes traditionally value. But we're buying companies because we think they can grow faster than everybody else thinks they can.

Do you come up with your own earnings estimates and then compare that with analysts' estimates?

Exactly. For every name in the portfolio, we have our own three-year forward earnings growth estimate, and those estimates are higher than the consensus. We

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assume that if there is an earnings growth estimate that most analysts are clustered around, that is the number that is discounted in the price of the stock at that moment in time. In other words, we think the market is very efficient in terms of pricing these expectations. So, the only time we want to be invested in individual stocks, or a group of stocks, is where we feel confident that the expectations we have are not recognized by most other analysts.

What is it that you see that Wall Street analysts tend to miss?

Well, I don't know. I think that Wall Street is in the world of conventional wisdom and so certain areas are ignored. One of the ways you can tell this is through one of the screens we like to use: After each quarter, you go through and look for companies that have the highest percentage positive earnings surprises yet the lowest earnings revisions. What does that say? It's saying that these companies are reporting surprisingly better earnings, and either nobody believes they can do it again, or no one cares. That's where we would become intrigued.

When you look for earnings surprises, over how many periods do you want them to occur?

We're looking for at least one—one would get us to look at it. Then we may do further work to see whether or not there has been a surprise before. Sometimes there are earnings surprises because the company pre-announced something awful and the stock got killed. When they finally reported, it may have been better than they said, but it still wasn't good so we wouldn't be interested. The ideal name for us would be something that's been going along for two or three quarters reporting better than expected earnings and nobody has raised their earnings forecast.

Do you prefer to see larger percentage surprises?

We don't have any target. First of all, depending on where you are in a cycle, a 5% surprise might be significant for one quarter but not during a different quarter. What we're looking for is not just the surprise. We're looking for a surprise that's completely discounted. There are a lot of companies that have wonderful surprises and the next day you'll see them up five or six points. That's probably not going to be something we would continue to watch because we would assume that the marketplace has adjusted to that new information. Our fishing hole is a company that comes in with an 18% surprise and nobody cares, because then you get a possibility of a misperception and that becomes intriguing to us.

What are your earnings growth estimates based on?

They can, for example, be based on a new product, or an understanding of different demand factors. For example, we've had an overweighting in energy companies that's worked well for us this year, and we've been specifically skewed toward companies that are sensitive to changes in the price of natural gas. We have felt that prices would remain high, demand would be strong, and that would result in higher growth rates and much higher earnings numbers than people are currently expecting, and so far that's been working. Additionally, we continue to see skepticism, as expressed by the sell recommendations from Wall Street and their earnings per share estimates.

Do you tend to use a top-down approach, looking first primarily at industries, or do you examine specific companies, as well?

In the case of our energy stocks, that would be more of a "macro" call. But the ability to see which companies within an industry to own, and which ones have the operating leverage to capitalize on our view, is very much a bottom-up approach.

In other companies, our selection may have nothing to do with anything top-down; it may just come from individual companies, for instance, companies that may be restructuring or may have a particular product we feel will do well. We owned Dell for a number of years, although we sold it recently. We owned Dell because we felt very comfortable about the demand for their product, but specifically we believed their model for distribution—direct sales, which is now pretty much standard—was correct. Now, we believed in that and other people didn't, and that gave us the opportunity. That was very much a bottom-up call.

Do you have a list of companies you follow as prospects?

Yes. We'll own a maximum of 50 at any time, and we have a list of 100 that we monitor, of which the 50 we own are included. But there are certain things that have to happen before we would buy a prospective company. We don't buy them because we hope they'll come around. We're only interested in companies that have already turned but the perception is that they have not. Usually this kind of change only happens with companies that have disappointed for years and people have given up on them. By and large, most of them are worth giving up on—we're not contrary simply to be contrary. But we do like to pay a discount to our expected growth rate, so in this kind of market it doesn't allow us to own a lot of the super-growers that have never stubbed their toe, because many of these companies are selling at two or three times their growth rates. We don't own names like Coca-Cola and Microsoft and Merck, because they are already wonderful, fabulous growth companies and they're priced as such.

Many companies that are icons of growth today were owned in our portfolio when they were considered to be cyclical companies. Less than three years ago, Intel was a cyclical company that you weren't supposed to pay more than 10 times earnings for because the semiconductors

were cyclical. However, perceptions shifted, and people now feel the demand for semiconductor chips is secular. Actually, that was true with most PC manufacturers. Two or three years ago, almost 30% of our portfolio was in technology, with names such as Intel, Dell, Sun Microsystems—these names were just being given away because they were not perceived to be secular growth companies but rather cyclicals. Now they don't make it through our valuation discipline and we don't own them because we don't have confidence that they really are secular growth companies, and so we're not going to pay such a high a multiple for them.

What other factors do you examine in your evaluations?

We prefer companies where the growth rate and the profitability is underestimated and as that comes through, it would be achieved in a very real way so you have a chance of an increase in the price-earnings ratio.

For instance, we own some cyclicals that really are cyclicals—for instance, Alcoa is not going to turn into a secular growth company. We think it's mispriced, its level of profitability is misunderstood. But when that changes, the stock will grow only as the earnings grow and perceptions concerning earnings growth change, so it won't get a change in its price-earnings ratio.

We primarily are looking for companies that will see a change in ratios, but you don't get that very often. That's what stocks such as Dell and Intel have gone through. And that's what we are seeking with the energy companies that are in natural gas. Of course, if all we get is the earnings part, it'll be fine, we'll be grateful and we'll have nice stocks. But if six to 12 months from now, the growing perception is that these companies' level of growth is higher and the quality of earnings are higher, people will begin to perceive a higher growth rate for a longer period of time, and then you get the multiple expansion and a very exciting move.

You mentioned that you also take steps to try and reduce the volatility. What kinds of things do you do?

We try to beat the market with less risk than the market, and I've used REITs [real estate investment trusts] in the past couple of years to accomplish this. They have lower volatility and a much higher yield than the typical stock. I've also used intermediate government bonds for maybe 5% of the portfolio to dampen the volatility. We own Houston Industries, which is a larger utility, to dampen the volatility—I mean, it's not going to be a home-run stock.

What would cause you to sell a stock?

On each of the companies, we have specific price targets, set at 110% of the growth rate we're expecting. So, in other words, we think the company is overvalued when it is selling at more than one times our expected growth rate for the firm. For instance, we sold Dell, which we felt should grow at 25%, when it sold over 25 times next year's earnings. That's the happy way.

The other reason we would sell would be if something unexpected happened in the quarter. It doesn't have to be a disaster, and we're very careful of course, but if we look at our earnings estimate and we decide to bring our growth rate down and therefore, our target goes down, we may end up selling the stock.

A third reason is if in the first 45 to 90 days a stock moves against us by 15% for no reason that we can determine, we sell it. That doesn't happen very often, but it does happen.

Also, we run equally weighted portfolios—every stock is 2.5% of the portfolio—so normally, our 10 largest holdings will be whatever they are alphabetically. Once we get to the names, we don't try to say 'I like this one twice as much as that one.' So, if we have two or three stocks that are doing fabulously in this kind of market, where you get these huge moves, we're selling when they get out of line and we're buying other names that are underweighted.

For instance, as Dell was going up, you were continuously selling?

Right, and we're redeploying money into other names that aren't doing as well yet. That discipline forces you to put money into things that you otherwise wouldn't like to buy, and that's usually about the best time to do it. It also keeps you looking at your portfolio, because you certainly don't want to be putting money into anything that's not really working. It forces you to look at the stocks and if you say to yourself "Gee, I don't like this anymore and I don't want to put any more money into it," you have to ask yourself, "Why do I have it at all?" It forces that kind of conversation with yourself.

These are rules that I've developed over the past 21 years of managing money, and I've found them to work well for us.

Your performance has been excellent over the long term. To what do you attribute that?

I would say that some of it is the absence of bad things—we don't have a lot of bad things offsetting some good things. We've had some very good stock picking—REITs helped us in 1996, and in 1995 we were very heavy in technology.

Basically, every year or so we find five or six names that do really well. And then the rest of the mission is not to goof it up by doing something stupid.