Blending conservative, growth and cyclical stocks into a winning strategy

An interview with Peter Lynch, portfolio manager, Fidelity's Magellan Fund

Over the past several years, Fidelity's Magellan Fund has become one of the most popular mutual funds in the industry. Its success has largely been due to its performance. Barron's "Lipper Gauge" rates it as the best performing mutual fund over both the 10-year and five-year periods ending in June. For the last 10 years (June 30, 1975, through June 30, 1985), it has racked up a 1,371.92% return—or 30.9% on an annualized basis; and for the last five years its return was 322.09%, or 33.4% on an annualized basis.

In addition, Barron's lists the fund among the top 100 performers during the most recent bull market, from June 30, 1982, to the beginning of August, with a 159.44% return. During 1984, the return was more lackluster— 8.77% versus the S&P's 8.68%.

The popularity—and attendant publicity—has resulted in a huge increase in assets under management. As of the end of July, total assets stood at a whopping $2.8 billion under management. That's up from $59 million at the end of 1981 and $116 million at the end of 1982. The fund, however, has been around for some time—it was started in late 1962.

Magellan's investment objective is to achieve capital appreciation; it is considered a growth fund. Up to 40% of the fund can be invested in foreign companies.

Magellan has a 3% sales load. It is part of the Fidelity group of funds, located at 82 Devonshire St., Boston, Mass. 02109.

One question that keeps recurring is the question of size. Several studies have indicated that the larger mutual funds have a more difficult time matching the performance of smaller funds. Given the size of the Magellan fund (over $2.5 billion), do you agree with the findings? What are the size limitations?

Yes, I would agree with the studies. There are several different levels of fund size. You start with funds of $5 million or $10 million, and the next level would be a couple hundred million. Then $500 million is another level. And then $2 billion or $2.5 billion is the same as running $1.5 billion, I would say. But it's clearly easier to run a $20 million fund than a $2 billion fund.

But you think it can be done?

Well, this may sound awful, but I think the average person is underperforming the market. However, we are hoping we can beat the market with a $2.5 billion fund. I think the average person gets chewed up with commissions. He or she puts the money in at the wrong time or they take it out at the wrong time. So I think when it is all said and done, the average investor—professional or non-professional—would find it difficult to match that.

Our goal is to beat the market—and how many people have done it? We think we can do that with a $3 billion fund. But we can't do it as well as we could if we had $200 million.

What I am saying, is that if you were to compare this $3 billion fund with some other $50 million fund, you are better off with our $3 billion fund. Fidelity has a lot of funds. We've started a lot of small funds for people who want action.

How do you go about beating the market?

There are three ways we beat the market. One is by buying companies that are small and doing well. They are unrecognized and unpopular, and you hold them for five or six years, and people discover them. That's one standard avenue.

Another approach is to buy companies that are doing poorly—big companies that are doing poorly—and a year or two later they are doing well.

The third method is by buying conservative stocks, and if you are wrong you might lose 10% on them, and if you are right you might make 30% or 35%. You make the 35% if you are lucky enough, you check the fundamentals, and if they are what you expected, you sell it and buy another one. If you have six 30% moves, it is equal to four-fold. You can make a lot of money buying conservative stocks if you keep selling one and buying another. The trick is if you make 30% to 35% with Borden, you can't hold it for 44 years. You have to put it into Chesebrough-Ponds, and then into Unilever and then into Dart and Kraft. I think a lot of professionals, if they ever make a profit on a stock, they never sell it—they hold it forever because it looks so good. Someone comes in and they look at it and they say "Gee, the stock's at 60 and he bought it for 45." But if they ever looked at the date the stock was purchased they'd see 1951. So that's one thing that has helped us—about a third of the fund is in conservative stocks. Let's say you might have a hundred of those. Ten might go up, so you buy 10 more and add them to the ones that didn't go up.

Is all of the fund invested in one of these three fashions? Or do you have an index fund as a basis, or core?

The fund is—and this has been true since the fund was at $20 million—probably 25% to 40% growth companies. Those are more risky, but you hope to make doubles and triples. It's probably 20% to 25% in cyclicals at any given time, and maybe special situations. And the rest would be conservative stocks or bonds—we have bought 8% in bonds right now. And I would say those categories haven't changed much in eight years.

What is your definition of a conservative stock?

A large company with a dividend—it has a good record of profits, it is in a stable business, it doesn't lose money in recessions.

So you do have a core?

Well, that core changes a lot. But what some people try to do is to time the market. When the market is going down they will go to 30% to 50% cash. If they are right, that is terrific. But I've never been able to do that. So we always have about 30% invested in conservative stocks, and when the market goes down, if all of your stocks go down you don't make a lot of progress. So we might sell a conservative stock that we bought at 30 at 29 after the decline, and buy something we really like that just went from 18 to 11.

The beauty of that is that if the market goes up, conservative stocks don't beat the market, but they go up. If the market goes up 20%, they will go up 15% or 20%, too. It's much better than cash if the market goes up. And it is better than having your whole portfolio in one category—all growth stocks—if the market is going down. I've run the fund for eight years, and over that period, it is up nine- or 10-fold, but in the middle of all that it has gone down 10% to 20% seven times. Well, those declines would have been more if the portfolio had been entirely in one of those categories—not conservative stocks, but if it had been all growth stocks, all cyclicals or all special situations.

And what we do, is that when the market is going down, we tend to add to the growth companies and the cyclicals that we like if the fundamentals are fine. So it helps you when the market comes down.

What about the efficient market theory? Do you subscribe?

It might be true for the 500 largest companies—or the 500 most actively followed companies, because there are some large companies that no one follows. I think it is very hard to outperform the market with IBM, because there are a thousand people just as smart as I am looking at it every day.

But there are inefficiencies. Some people won't buy companies that have labor unions, or they won't invest in these industries, or they will never buy a railroad, or they only buy companies that start with the letter "r." There is a lot of prejudice out there—and I have none of those. As long as they aren't doing anything illegal. I buy foreign stocks, too. About 15% of the fund is foreign stocks, and I don't think that is an efficient market. At the one point when I liked the chemical stocks, I bought a lot of U.S. chemicals and I started looking at foreign chemicals, and I bought those because they looked more attractive. I think it was a good move. I did the same thing with automobiles, and that worked out well. I did it with steels, and I shouldn't have bought steels, but I lost a lot less in Canadian and Japanese steels than I lost in American steels.

What is your basic approach? How do you find the stocks?

Well, I see 400 companies a year or so, maybe half of them in Boston and half of them on the road. A lot of it is going to these conferences where they will bring out the management—the president, chairman, vice-president. I make a lot of telephone calls. We also have about 25 analysts at Fidelity, and they are all calling companies, and they bring in ideas.

A lot of times, when you buy a stock, when you first buy it there are three or four negatives and there are four or five positives. You are in the middle, and you buy a little bit, and you keep checking in and tuning in with the company and some of the problems get worse or they get better and you buy more stock. That way, you can take advantage of the movement in the stock market. Sometimes the stock goes down and the fundamentals get better. So you buy more stock.

You spend a lot of time talking to companies. What information are you seeking when you call a firm?

Primarily you want to find out what they do—what is the nature of the company, why are they doing poorly, who are their competitors? Mostly, you want to understand what is it that this company does? You have a real good idea of what General Motors does, but you don't have the foggiest idea of what some of these chemical companies do. Even Sears Roebuck is pretty complicated. You are trying to find out what they do. If they are doing poorly, why are they doing poorly? What is a reasonable expectation for them to do better? And if they are doing well, you want to make sure there is some reason that they did well. If you can't really prove to yourself that there is a valid reason that they have made a lot of money, then you shouldn't be considering the stock.

You don't do any market timing. Why?

Because when I am most optimistic about the market it usually goes down, and when I feel the worst it goes up. I don't see any advantage to trying to predict the market. I could spend six hours a day thinking about the market and what good would it do? My odds of being right are about one in three.

Yet it remains a popular strategy with investors.

I think that is why they can't match the market. After it goes up about 150 points, I hear from people I haven't heard from since college. They never call me when the market is going down.

What have been your biggest mistakes?

I would say the biggest mistakes have been in companies with a lot of promise and huge potential, but where there is really no earnings yet—it is one or two years away. It would be an enormous hit if everything went right. I might have done 15 or 20 of those in my life, and I don't think I've broken even in one of them—I've lost 20 straight times. I've had stocks where I have made 10- or 12-fold on them, but they were stocks that I expected to make 30% to 40% off of. I have found there to be no correlation between my enthusiasm for stocks and what happens to them. Well, it might be a negative correlation.

What about industry groups? Do you prefer one to another?

Usually I am looking for some industry that is getting better. Sometimes it is supermarkets and sometimes it is electronics. And when I find them, I buy a lot of companies in it.

It usually starts out that I see a particular company I like, then I look at other companies in the same area. In other words, whatever is happening to the first company is happening to everybody else. I think I own 95 savings and loans now. It starts off by first seeing one, and then I notice that it is in an industry that is really turning around. So I say, "Gee, maybe I can find a few more of these fellas."

What kind of advice would you give to individual investors?

First, I would tell them to look at the balance sheet. A lot of times they look at companies and just look at the earnings, and they say they are doing poorly now and some time in the future they will be doing better. You can check a company's balance sheet in a place like Standard & Poor's, and you ought to see if the company is going to be around in the next two or three years. So I think people should focus on the balance sheets and the financial operations. When I try and buy a down-and-out company, I want to first be convinced there is a good chance that when they come back, they will make a lot of money that won't be diluted out by their having to sell a zillion shares of stock.

The other thing I would say is that just because a stock has gone down, it isn't necessarily good. A lot of people feel that if a stock goes from 60 to 40, on that basis alone it's a buy. I've tried it myself, and it doesn't work very well. That's known as bottom fishing. I think people get too carried away with the fact that the stock has gone from X to half of X, and on that basis alone they invest.

The other mistake I would say the public makes is that they don't use the information they have from their own fields. Let's say they are in the insurance industry or the chemical industry or the drug industry, they see these industries getting better or worse and they can use that information. Here, they will be doctors prescribing a new highly successful drug, where the stock of the company goes way up, and they will go out and buy biogenetic technology. They think biogenetics is the thing of the future. That's kind of silly. They will do all this research—go to the library, call friends, check the consumer magazines—to buy some $800 appliance, and they will put $5,000 in some stock for some stupid reason. It is totally illogical. I think the average person doesn't feel there is any rhyme or reason to the stock market, and he just plays it like it is a game. And I think that the average person should work hard, and really take a look at what he owns and why he owns it.

The other mistake [individuals make] is listening to stock tips. They should be going on the basis of what is the story behind the stock. You should approach it as if it was presented to you anonymously on a sheet of paper, instead of putting faith in this individual who has provided the tip.

Do you think individuals can outperform the market?

Sure. They don't have to buy 300 or 400 stocks. They don't have to convince anybody—it's their money. We [at Fidelity] give a lot of responsibility to the individual portfolio managers, but at a lot of firms, banks, and trust companies it is very regimented. Some firms couldn't buy Chrysler, because they said it was going bankrupt. Individuals don't have to worry about that. They've got all the information—the annual reports are good, the quarterlies are good, they can call the companies.