

Traits to Look for in Growth Stocks

An Interview With Robert Bartolo, CPA, CFA

Article Highlights

- Growth stocks have earnings per share growth of at least 10% per year, though sales growth is also an important component.
- A higher multiple for a growth stock can be justified if the addressable market is large and the company has a sustainable competitive advantage.
- As long as a company is doing well, its stock should be held onto because the compounding of gains is how big returns are made.

Robert Bartolo manages the T. Rowe Price Growth Stock fund (PRGFX), the oldest growth stock mutual fund in the United States. We spoke about what he looks for in a growth stock.

—Charles Rotblut, CFA



1% or 2% and even a -1% sometimes. They don't build a tremendous amount of stores, so for a lot of years their top line wasn't very good. But their stock traded at nine or 10 times earnings, so the company bought back a lot of stock every year to get that nice bottom-line growth.

Charles Rotblut (CR): As a portfolio manager, how do you define what constitutes a growth stock?

Robert Bartolo (RB): In terms of the objective for the T. Rowe Price Growth Stock fund (PRGFX), we basically look for bottom-line growth. In most cases that's earnings per share (EPS), but in some cases it is free cash flow per share. Bottom-line growth of at least 10% is the "definition," per se. Top-line growth is also very important to me as a growth investor, because at the end of the day, there are only so many ways a company can increase its margins—buy back stock and do different things. If a company wants to sustain really good bottom-line growth for a long period of time, it has to have a good, or at least a decent, top line.

CR: When you're looking at the earnings growth, are you looking for 10% growth in earnings per share, net income or both?

RB: Per share.

CR: And do you make any allowances for the share buybacks?

RB: Yes, if a company has proven that it is a consistent part of their strategy to buy back stock and that helps them to achieve better bottom-line growth and achieve 10% plus, then that's definitely something I take into account. One of the companies I own is AutoZone (AZO), and for years and years their comparable ("comp") store sales were a positive

CR: Speaking of returning capital to shareholders, what is your view on dividends? There is a perception that if a company hadn't paid dividends and starts to pay dividends, it's a sign that maybe their growth rate is slowing or that the company is maturing.

RB: My view on that is that if there are high-return opportunities for a company to invest their cash flow in, I want them to do that first. If there is not, then they should return the free cash flow to shareholders. If your stock trades at a reasonable multiple and buying back stock is going to create long-term growth to the company, then I'm definitely in favor of buying back stock first. In the case of dividends, I'm not averse to them. I don't see dividends as a sign that the growth is over for a company. So, dividends would be my second preference in terms of returning capital to shareholders. For instance, in cases like Apple (AAPL), where they have so much free cash flow, I think paying a dividend has been somewhat helpful for them because it has opened up their shareholder base to dividend investors.

CR: Since T. Rowe Price Jr. started the very same fund you now manage, how is your strategy similar to his and how is it different?

RB: That's a good question. I wasn't around during that time period, but from what I understand, it is pretty much the same. At the time, it was a new and novel strategy. It

seems weird to us because it is such a staple of a strategy now. But at the time it was kind of a new strategy in trying to find companies that were going to grow their earnings much faster than the market and, therefore, if you buy them at reasonable prices, your returns should beat the market. That was kind of a new idea, and I don't think the idea has changed much in terms of what I do.

CR: *In terms of valuation, that's always a concern: Some growth stocks seem like they have their growth already priced into them. How do you value these companies? Particularly if they have a high growth rate, how do you determine an appropriate multiple to pay?*

RB: To me it's based on three things. The way I invest, it's based on how big the company's addressable market is. In the case of companies like Apple and Amazon (AMZN), they have really massive addressable markets that are global. The second thing is the company's sustainable competitive advantage: How strong I feel their competitive advantage is that is going to allow them to take market share and grow or maintain their margins over time. The third thing is valuation, which you asked about. If I feel really good about those first two things—how big the market is, which really gets to the duration of growth, and then how strongly I feel the company's sustainable competitive advantage is—I'm willing to pay a higher multiple for that company. If I feel less good about one of them, then I have to take that into consideration with the multiple.

In general, though, I think there are a lot of people in the market and there are a lot of shorter-term investors, and the market has become so short term that a lot of times faster growth seems to be undervalued by the market, at least in recent years. There has been a lot of turmoil in the markets in the last 10 or 12 years with the dot-com bust and the financial crisis and other things, so in general I think most people are risk-averse. There is only so much that people are willing to pay for a company growing their bottom line around 70% for the past several years, like Apple has been doing. As we speak in late

Table 1. Performance of T. Rowe Price Growth Stock Fund

	Total Return				Yield (%)	Expense Ratio (%)
	YTD (%)	2011 (%)	Annual Avg Last 3 Yrs (%)	Annual Avg Last 5 Yrs (%)		
T. Rowe Price Growth Stock (PRGFX)	13.2	(1.0)	17.7	1.9	0.0	0.7
Average of Large-Cap Stock Funds	8.4	(0.9)	15.0	(0.2)	0.8	0.9

Source: AAI's Quarterly Low-Load Mutual Fund Update, January and July 2012. Data as of June 30, 2012. Bold returns are in the top 25% of all funds within in the investment category.

July, Apple has been trading under the market multiple of 15. I think that type of growth is worth a lot more than that.

CR: *An individual investor looking at some of these growth stocks may not feel like he has enough information to form his own discount cash flow model to value a growth stock. Is there any guide for valuation that investors can kind of look at to evaluate whether a stock is trading at a discount to its growth possibilities?*

RB: I think individual investors have the same information everyone else has, but they just may not have the expertise to analyze it; all the information is out there. If I am giving advice to an individual investor when looking at growth companies, I would say you want to look at top-line growth and what you think the prospects are for that. Look at the EPS growth and whether the company is able to turn top-line growth into bottom-line growth. You want to look at cash flow and how cash flow compares to earnings. And you want to look at what the company is doing with the cash flow: Whether they're having to invest it all back into the business through capital expenditures, etc., or doing acquisitions, or if they're able to return, or willing to return, a lot of it to their shareholders. Individual investors have to make the same judgments I have to make in terms of how much they're willing to pay for a company like that. The old rule of thumb is a price-earnings-to-earnings-growth (PEG) ratio of less than 1.0—if a company is growing faster than its price-earnings ratio, then that's generally a reasonable valuation.

CR: *How do you tell that growth is going to be sustainable into the future when analyzing a company?*

RB: That's the art, right? That's the secret sauce. That's what we get paid to do in terms of studying the company, studying the industry and all the different players. Evaluating all the market forces and whether a company can fend off competition and gain market share. Those are the judgments we make.

CR: *Is there anything that you look at to see if a company is able to fend off its competition?*

RB: You look at what makes that company special, whether it is the people that work there or the products or the intellectual property that they have or own. It could be a concept, too, like Chipotle (CMG), for instance. There are a lot of different things you look at. It depends on the company.

CR: *Your fund holds a lot of technology positions. It seems like there is a lot of change right now, with a lot of the old leaders being uprooted. Do you have any suggestions for individual investors looking at technology?*

RB: Technology seems to be an industry where companies that have strong operating momentum tend to stay strong, and companies that don't tend to stay weak. My advice would be that you want to invest with the companies that have strong momentum and that are disrupting the old companies. I try to stay at the right side of secular change in technology. If you see a company like Amazon and they introduce the Kindle, that has a lot of implication for companies like Barnes & Noble (BKS). So my philosophy in

technology is that you always want to have time on your side and you want to be in the innovative companies and the companies that have operating momentum because those companies tend to maintain that momentum.

CR: *Are there any concessions you make in a slow economy in terms of growth? Do you allow companies to report slower growth? How do you tell who is able to maintain their historical growth rates or momentum?*

RB: I think you definitely have to take into account the macro-environment that a company is operating in, so you don't misjudge the execution of the company. For instance, I've had a couple of companies in the portfolio that have reported slowing sales for the second quarter—Chipotle is one of them, and Starbucks (SBUX) is the other. So you have to make the judgment: Is this a company-specific problem, or is it just the macro-environment slowing and the consumers pulling back a little bit? Do I stick with those investments or buy more? I would say, in a slowing economy, you don't want to be too quick to throw out what you think are winning investments or winning companies over time. You want to give them more benefit of the doubt.

CR: *If a company has a slowing growth rate, either because of weaker sales or, as it seems occurred quite a bit in the second quarter, because of the stronger dollar, do you allow the company to have one bad quarter and see what happens the next quarter?*

RB: It depends on why you think they had a bad quarter. If it's because currency went against them, then I generally don't penalize the company for that. If it's something that I think is more fundamental and that the company actually lost market share versus the competing companies, then I would take a more serious look at that in terms of evaluating my thesis on the company and how I feel about the company. It really depends. If it's

currency, I wouldn't worry about it. If it's a consumer-pullback that a lot of companies saw, I don't worry about it so much. If it seems more like it's a company-specific issue, I'd be quicker to potentially sell.

CR: *I believe your philosophy is to hold onto stocks as long as possible. Addressing volatility, both in terms of earnings and price fluctuations, is the strategy that as long as the business is going in the right direction to continue holding onto it?*

RB: Yes, I would say that's right. As long as we feel good about the long-term investment and nothing has changed on our thesis of the company, then we want to hold on as long as they're doing well and gaining market share. That's kind of the philosophy—to compound those gains over time.

My turnover generally has been about 30% to 40%. So generally I'm holding onto a company for about three years, some companies much longer than that and others shorter. But that's the general philosophy. As long as the company is doing well, you want to compound those gains because that's where you make the big money. A lot of times in growth investing you make a lot of your money on a few names that really do well and compound over time, so you don't want to be too quick to sell those. One Apple can make up for a lot of mistakes and other companies that disappoint you along the way.

CR: *What about cyclical stocks? Sometimes you can have companies that have good long-term growth, but if the economy weakens, their earnings go down with it. Do you consider those, or do you tend to avoid those?*

RB: I'm definitely open to more cyclical companies. I try to invest in what I would call, "growth cyclicals" that over each cycle are making higher highs and higher lows. If I really do a good job, then I'm buying them on the lows of each cycle and maybe trimming or selling them on the highs of each cycle, but

that's hard to do. A lot of the examples are in the energy space, where you have the cyclical swings and the commodity prices. But if I'm investing in a company that is growing their production every year, then hopefully those highs will be higher and those lows will be higher than the last cycle. It's the same case with industrials: You have cycles there that happen. There are some good growth cyclicals in there, though, where over a five- or 10-year period you can make some good money.

CR: *Finally, any concerns on being overly concentrated in one sector? Depending on where we're at year to year, it seems certain sectors have more growth than others.*

RB: T. Rowe Price Growth Stock fund is a diversified fund, and so we're always going to be well-diversified.

Technology is the biggest sector, with about a third of the fund. That's not too different than what you would see in a growth benchmark—it's in the 30% range. So we're not particularly overweight, even in technology versus other things. And there are a lot of companies in there that are classified as technology that I wouldn't really say are tech in terms of what you would think of it as, such as Visa (V), MasterCard (MA) and Accenture (ACN).

We don't want to get overly concentrated in any one sector, but technology is the biggest place where we do find attractive bottom-line growers, so that is why it's the biggest.

CR: *Is there anything else you think an individual investor looking at a growth stock should consider?*

RB: As an individual investor, you can find a lot of these growth names just in your everyday life. There aren't a lot of people who haven't heard of Apple, Chipotle, Amazon or Google (GOOG). Just try to find those special companies, and if you find the really good ones, you can still buy and hold them and make a lot of money compounding over time. ▲

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