Fund focuses on the stocks of mid-sized companies that typically have proven themselves but still have room to grow.

A Search Among the Mid-Caps for Growth at a Reasonable Price

An interview with Brian Berghuis, portfolio manager, T. Rowe Price Mid-Cap Growth Fund

Many investors tend to think of stocks as being either large or small. There is, however, a mid-range of stocks that this classification overlooks.

A small number of mutual funds focus on this medium-sized sector. One with a relatively short but particularly good track record is the T. Rowe Price Mid-Cap Growth Fund.

The fund was started in 1992. It was among the top 50 performers for the last three years ending December 31, 1995, with an average annual return of 21.2%. Last year, the fund was up 40.9% compared to 29.8% for the average growth fund and 30.9% for the Standard & Poor's mid-cap 400 index; in 1994 the fund was up 0.2% compared to –0.4% for the average growth fund and –3.6% for the S&P 400; and in 1993 the fund was up 26.2% compared to 13.8% for the average growth fund and 13.9% for the S&P 400.

The fund currently has about $425 million in total assets.

In late March, portfolio manager Brian Berghuis discussed the management of the fund with Maria Crawford Scott.

What's the basic objective of the fund?

The objective is capital appreciation. We don't have any yield requirement, and a lot of the companies we own don't pay dividends because they're growing and need to reapply the capital to their growth.

And the focus is on mid-sized companies as defined by market capitalization (number of shares outstanding times share price)?

Yes, we're focused on mid-cap stocks. We define those using the parameters that Standard and Poor's uses for their mid-cap index—roughly $300 million market capitalizations on the small end going out to $4 billion on the high end.

The average market capitalization for the fund right now is $1.7 billion, but our range in holdings is quite wide. I almost never buy a stock below $300 million, although occasionally something I bought at the low end goes the wrong way and creeps into the small-cap area. A little more frequently we've had stocks creep over the high end of the range. Obviously, that's the best way for us to get out of our range. We don't necessarily sell stocks that drift out of the range on top if I feel the fundamentals are strong and I still like the company. But once a company's market capitalization becomes significantly greater than the upper bound, I begin to look at it tactically, and so I would be more inclined to sell it on even a faint sign of problems.

Do you see very many large-cap companies that have become severely undervalued and drop down into the mid-cap range?

Only very occasionally. That would be more in the perview of a mid-cap value fund and that's not really my style. More often I'm buying companies that we're familiar with from the small-cap side of things, and that's natural, because they are the companies that tend to be growing.

Why do you focus on the mid-cap range?

Several reasons. Historically, the mid-cap area has proven to be a good area in which to invest. A few years ago we did a study of mid-cap stocks relative to small- and large-cap stocks since 1926, and we found that mid-caps performed almost as well as small-caps, but with less volatility. And mid-caps have outperformed large-caps in every decade since the 1930s.

Mid-cap companies typically have proven their conception, but have room to grow, so their stock prices grow as well. In the large-cap area you have a mix of companies where some are growing and some are shrinking, and in the small-cap area you have some companies that are growing quite nicely while others just can't grow, and so they disappear.

In addition, a lot of the large-cap companies today are followed by 25 or more analysts, but in the mid-cap range, most of the companies we own tend to be followed by 10 or fewer analysts. So the market is a little less efficient and that tends to lead to more opportunities.

What do you look for in a company?

We try to identify companies that are still in the early stages of development with good business models that will prove out in the long run. What you get then, over a period of years, is an expansion of price-earnings multiples relative to the market. And if you can get that along with good earnings growth, that's a very powerful formula for share price gains.

Another criteria that I use is a projected annual earnings

The T. Rowe Price Mid-Cap Growth Fund is part of the T. Rowe Price family of funds, P.O. Box 89000, Baltimore, Md. 21289-0220; 800/225-5132.

growth rate of at least 12% over the next three to five years, and typically the companies that we own are growing faster than that. The average for the companies in the portfolio over the last several years has been about 20%, which is where it is now. And I tend to look for industries where there is good growth because a positive backdrop can be very helpful. I look for good business models, and by that I mean companies with good operating leverage, where there are recurring revenues as opposed to one-shot revenues, and where I can be fairly confident in the ability of the company to achieve the growth rate that I have projected. I also look for strong managements with decent depth, and by that I mean that if someone leaves, we would like to be able to think that the operation will continue fairly flawlessly. I look for companies that are market share leaders, or have clear competitive advantages in their field. I like companies that have strong cash flows, and can internally sustain their growth. And I look for reasonable valuations.

Of course, people always ask me: What's a reasonable valuation? My answer to that is I don't have a mechanistic approach. In fact, some companies we value differently from others. For instance, we would tend to value our telecommunications and media holdings on a cash flow basis rather than an earnings basis. But in general, I'm looking for companies that are trading at reasonable price-earnings ratios relative to the market as a whole.

How do you define the "market"—the S&P 500 or S&P 400 mid-cap index?

You can use the S&P 500 or the S&P 400 mid-cap index—the market multiples are pretty similar in the two groups. Right now we figure that this year the S&P 500 is trading at about 16 or 17 times 1996 earnings, and most of my companies are at a modest premium to that.

The composition of the fund's portfolio is somewhat different than that of the S&P 400. What are the differences?

The S&P mid-cap index, like the S&P 500 index, is a widely diversified index. Both indexes contain growth and value stocks. Two of the value sectors in the S&P mid-cap are fairly significant—utilities and financials—and at times have accounted for as much as a third of the mid-cap index.

And those are areas that the fund doesn't go into?

I have a very modest exposure of about 10% in banks but the index is probably closer to 16% or 17%. And I own no utilities whatsoever. They really don't meet the growth criteria.

What would cause you to sell a stock?

There are really four criteria for selling. The first one is deteriorating fundamentals. When I see deteriorating fundamentals that are company-specific, and not the result of a falling economy or an industry downturn, I tend to sell a stock.

Secondly, if the investment thesis that I was adhering to when I bought the stock changes, I will sell. For instance, say I buy a company that's growing nicely within its niche, and my thesis is simply that over time it will be better recognized in the market. And let's say that management goes out and buys another company in a completely different market segment and, in effect, asks shareholders to make a leap of faith and believe that they can manage something outside their traditional area of expertise. In that instance, I will sell the stock.

Excessive valuation would be the third reason. I won't sell a stock just because the price has gone up, but I will sell a stock if I feel that the valuation has become particularly excessive.

Finally, the fourth reason to sell is if it can be displaced by a better idea. I try to stay fully invested and sometimes if I see a really good stock I have to sell another stock to make room for it. That's probably the best reason to sell because it forces you to critically look at what you have and create room for a good idea.

Last year, the fund's performance was terrific, bettering both the S&P 500 and the S&P 400 mid-cap index, which didn't fare as well as its large-cap counterpart. What accounts for the difference?

I don't know—in looking back at the fund's performance, it was fairly consistent and not the result of just one great quarter. We were helped by our top holdings—we had some big winners in the business services area. Another reason is that we did well in the consumer area, and yet that part of the market as a whole didn't do very well. If I had built a portfolio only using a top-down perspective, I probably would have underweighted the consumer area, but I kept finding consumer stocks that I thought I could make money in—Tommy Hilfiger, Circuit City and others.

Why did you feel you could make money in a sector that wasn't doing so well? Why, for instance, did you like Tommy Hilfiger?

Tommy Hilfiger was the second biggest contributor to the fund last year, so that's a good place to start. We bought the stock in late '94 at about $20 because I saw what I thought was a reasonably good backdrop to growth. And that was simply that this company was taking advantage of the casualization of male dressing in America, and particularly the casual Friday trend, which hasn't yet reached T. Rowe Price, but is very much evident out there when I visit companies on Fridays. The company has basically come out with an updated, classic, casual look that's become fairly popular, yet at the end of '94, they had a very small presence in many areas of the country. In my view, they had a proven business concept that was doing well on the East Coast and in the South, but that had not really reached the mainstream in the Midwest, Southwest and California. Plus, they had the potential over time of significant product extensions. They had good management, a good balance sheet, and they internally sustained growth—it met a lot of the criteria that we look for. It was a good stock last year and I think the outlook is still strong.

And the fact that it was in consumer services didn't bother you?

I guess the lesson here is that even though I do keep an eye on the top-down situation, I won't let that overwhelm stock picking.

The fund also stayed out of technology last year. Why?

I felt very, very good about how the fund performed last year since I had underweighted probably the best performing group, overall. Why did I underweight it? Good question. Two reasons. One is that, although I think technology over the long run is a very exciting growth area, I felt through all of last year that the area was much more cyclical than people were giving it credit for. The attitude last year was that you didn't have to worry about cyclicality anymore. In fact, on my bulletin board here I have a headline from the New York Times business section dated July 17, 1995: "Tech Stocks Defy Gravity and Rewrite Conventional Wisdom." I pinned that on my board because July 17 was probably the peak of discomfort for me on the tech side. With that article, I became convinced that I was right.

Technology had been very cyclical through the '80s and even into the very early '90s. But then, starting in 1992, there was a straight move up, due in large part to a huge consumer boom in personal computers that was overlaid on top of the traditional corporate technology cycle. And that led people to believe that technology was no longer cyclical. My point, though, is pretty simple, and that's that corporate technology needs are cyclical, and consumer needs in other areas are cyclical, so there's no reason the consumer would not prove to be cyclical in a fairly high-tech purchase like a computer. And I think that's what we're seeing now. As technology stocks began to swoon a little bit in the fourth quarter of last year and the first quarter this year, the underweighting in technology has probably helped me.

Yet you do have some technology stocks.

Basically, when I think we are in a down cycle I underweight the sector from a top-down standpoint, but I still own names that we think will be good over the long run. I'm not willing to be completely devoid in a sector. And one of the ways that we did try to ameliorate the downside risk a little was to buy companies that employ technology like computer processors, but not necessarily companies that sell the technology. Instead of owning companies that make computers, or make computer components, I owned companies that, for instance, process credit card transactions or healthcare claims.

And what about another technology holding—America Online?

That's one of the more volatile stocks that I own. My original thesis on America Online when we bought it about a year and a half ago was that this is not simply an [Internet] access provider. I thought at the time—and I still think—that [providing access] is a real commodity business where the big telephone companies can come in and basically take the shares at will because they have incremental capacity at virtually no marginal cost. But I felt America Online had the possibility of becoming a bundler of content, in effect, a cable company on a national scale. Right now the Internet is a chaotic jungle and if a company like America Online can more creatively bundle content that's of interest to a large number of people, I think that's a very legitimate service that might grow quickly. America Online saw very early that the consumer market was probably the best market to go after. Companies such as CompuServe that have been in this business for many years serving the more technical audience have done very well at higher prices, but they now realize the America Online business model is a better one and they're trying to catch up. But they're way behind. And other competitors are dropping by the wayside.

We'll see how America Online executes. It's not a huge holding, but it's obviously a very, very good stock. It's about tripled since I bought it.