INVESTING IN SMALL-CAP STOCKS: LEADING THE PACK BY NOT FOLLOWING IT

FUND FACTS

LIBERTY ACORN FUND (ACRNX)

CATEGORY:
Growth

PERFORMANCE: (thru 6/30/01)

	Fund	Category
Compound Annual Return (%)		
1 year	21.6	0.0
3 years	14.9	6.1
5 years	17.6	13.2

RISK
Low

TOTAL ASSETS: (as of 6/30/01)
$4.5 billion

CONTACT
800/922-6769
www.wanger.com

Few mutual funds have had as long of a track record as the Liberty Acorn Fund. Even rarer is long-term performance that consistently beats its peers.

The AAII Journal *first interviewed Acorn's portfolio manager, Ralph Wanger, back in 1983 when his approach and performance record were starting to attract attention.*

Today, the Liberty Acorn Fund is a well-established mutual fund granddaddy, with over $4.5 billion in total assets. Yet it has remained true to its small-cap investment strategy, and it continues to best its peers over long-term time periods. Most recently, the fund was among the top 20% of all growth funds for the last year, three years, and five years through June 30.

How has the fund been able to preserve its record? In early July, Maria Crawford Scott interviewed co-portfolio manager Charles McQuaid.

What is the basic investment objective and philosophy of the fund?

We're looking for small-cap stocks, and our preference is for growth stocks that are selling at a reasonable price. We tend to lean toward value when value is cheaper, and we lean a little toward growth when growth is cheaper, but on average we're in the middle, between growth and value.

Essentially we are looking for a good business at a reasonable price. Our ideal is to buy a company at a third of what we think it's worth. We are hoping that its underlying value will double over five years and that the company will get recognized and no longer sell at a discount. That gives us a triple in five years if it works out.

When you look at our portfolio, the thing that really has distinguished us is the kind of stocks in the portfolio. Most portfolio managers in our industry are trying to outguess each other, but we are playing a different ball game. We're looking for less volatile, misunderstood stocks where we can get a fundamental edge because they're not being followed too closely by Wall Street.

What is your definition of small-cap?

When we buy stocks, we like to buy them below $1.5 billion in market capitalization [the number of common shares outstanding times share price], and preferably below $1 billion. Once a stock in our portfolio gets over $2 billion in market cap through appreciation, it warrants additional scrutiny, although it doesn't necessarily get kicked out.

Essentially, our universe is the Russell 2500—the Russell 2000 plus about 500 essentially mid-cap stocks. Plus, we do have some foreign holdings—foreign represents about 7.5% of our portfolio currently. When you put it all together, we have about 180 or 190 domestic, small-cap stocks in the portfolio, which is under 10% of the Russell 2000. So basically we try to choose what we consider to be the best 10% of the Russell-2000-type stocks.

How do you value a stock?

We try to fit the valuation model to the type of business the company is in. For a traditional growth company, a dividend discount model can be very effective—we use it as a base line and then try to look beyond reported earnings per share. Some companies, for example, might have goodwill amortization, which by the way is going to go away [due to changes in the accounting rules]. In the past, we've been able to buy companies that had goodwill amortization at discounts because many investors looked only at their reported earnings, while we would look at reported earnings and add back goodwill.

However, there are a lot of companies where a private market valuation model might be more appropriate. For these firms, we will look at proxy statements, merger agreements, and things like that to see what similar companies are actually selling for in the real world. For instance, when one company acquires another, we look at the documents to see what kind of valuation metrics were used in that acquisition.

In some industries, particularly media-related industries, we find cash flow models to be the best valuation measures. Real estate would also be in that category.

And then you are looking for a stock that is selling for one-third its value?

It really will depend on its risk category. We will demand a higher return if we think a company is a higher risk. So 33% is a rule of thumb, but basically we are looking for a greater than 20% compounded return for a couple of years. Depending on the company's growth rate, a 33% undervaluation would match that because the company is growing while we're waiting for valuations to improve.

Your fund report mentions stock holdings that fit into 'themes.' How do you pick these themes?

It is really a result of our system. What we do is try to predict what we think a stock is going to be worth in a couple of years, based on our valuation models. Our system automatically tells us when one particular group is expensive because the expected return from these models drops.

For example, the year before, when technology was really hot, we had very few tech stocks show up as high-return stocks in our models. That helped us choose to underweight the industry.

We look for solid businesses that have real substance, and within that we have some themes. We don't let these themes drive our investments, per se, but once we find a potential stock that really fits our theme, it reinforces our decision to follow it and buy it.

Our long-standing theme has been our 'information' theme. In fact, Ralph Wanger asked me way back in 1978, when he was recruiting me, "How can you benefit from the declining cost of computing?"

This was a test, I take it?

Basically. He said that the new computers were getting faster all the time, so how do you benefit? The answer is downstream from technology—companies that use the computers seem to benefit more than companies that actually make the computers.

International Game Technology is the best example. They make slot machines, and they were the first company to really use microprocessors and electronic components. They were competing against companies that were basically gear-heads, making old-fashioned slot machines with a lot of gears and pulleys and motors and buzzers—basically electromechanical devices that would break down a lot. Moving to electronic components was a huge improvement—these machines last longer, there's less maintenance, and they provide much better information feedback to the casino owner. That's an ancient example, but we made money on this stock recently for the same reason.

Other examples include Kronos and Micros. Kronos makes punch clocks for hourly workers. The old punch-clocks were Rube Goldberg-type mechanical devices, but these new electronic ones can scan an employee badge with a bar code; you don't have any transcription errors, and it automatically takes the data to the payroll department. Mircos is a company that makes specialty computers for the hospitality industry—both restaurants and hotels.

All three of these companies are basically taking generic chips, adding a lot of customized software, and then selling the product for a lot more than a PC.

Acorn also currently holds stocks like Anchor Gaming and Station Casinos—is that part of the same theme?

They're very much related to the same theme. Casino operators are just a bit farther downstream from technology than the slot machine companies themselves. The casino operators benefit every time a brand new slot machine comes out that's better than the old one.

What about your financial services holdings—for instance, Neuberger Berman, which has a number of competing mutual funds?

We've had a number of winners in financial services, and there are a couple of themes there—it's an intersection of one theme, which is our information theme, and another theme, which is our 'saving for retirement' theme, based on demographics and the huge number of baby boomers that have to save for retirement.

Neuberger Berman plays into our saving for retirement theme. But our top holding right now is AmeriCredit, and its been a wonderful stock during the last quarter. AmeriCredit provides used car loans to people without great credit ratings. How can they do that? Well, you do that if you have good computers. This used to be a backward industry where guys would go out with baseball bats to collect the money. AmeriCredit instead tries to more properly calibrate the risk, and they then price loans accordingly. And AmeriCredit has benefited as competitors have exited the business—it's not a good business if you don't do it right.

What other characteristics do you look for in a company?

We want to have companies that can pay off their debt, although we're not frightened away by a little bit of leverage. Equally important is management—you want to have management that's building a business. One of the biggest traps you can fall into in this industry is to buy a stock that looks cheap, hold it five years, and then realize it hasn't grown—and of course the discount hasn't shrunk—because it is being incompetently run and basically driven down in value over time.

What kinds of things do you look for in management?

The financials will be the first indication as to how the company has been run—typically, better-managed companies will have better margins compared to others in the same industry. Management should be decisive, they should have a good track record, and they should be shareholder-friendly—we want their interests aligned with ours. So we like it when management's stock ownership is more important than their salary. We want management to get rich as shareholders get rich.

What about your foreign stock holdings—how do you find and value them?

We have a whole team of people working on international stocks, and, of course, we have Acorn International Fund.

We value them very similarly to U.S. companies using dividend discount models and other models including product market value. Essentially what Acorn Fund itself is trying to do is cherry-pick some of our best international ideas, and we find that some of our themes work overseas. A third theme for Acorn has been leisure—as the population becomes more affluent, particularly as it becomes older in most of the developed world, people want to take vacations, so leisure is a third theme.

But international stocks are only 7.5% of the portfolio currently, and we expect to keep it long term around 10%. We use it for diversification and for unusual opportunities, but we don't consider Acorn a global fund, because it isn't.

Why would you sell a stock?

There would be a couple of reasons. One is qualitative. In our research database, we have clearly stated reasons why we own each stock. For instance, THQ makes electronic games, and reasons to own would include product momentum because they have to come up with hot titles to sell, and long-lived franchises, where they have not only today's hot product but also products where they can do sequels.

If the fundamentals change and one or more of those reasons evaporate, we have to reevaluate the company and figure out what to do.

The other reason would be quantitative, where our valuation model would point us toward selling because the stock has become overvalued. Now typically, these two reasons are related because if the qualitative reason we own the stock goes away, we have to revise our forecast for earnings and it would make the stock less attractive on a valuation basis.

However, typically we buy stocks with long time horizons. If you look at our turnover rate, it's substantially lower than most other mutual funds. In fact, our turnover rate would be lower if some of our companies had not been sold out [through acquisitions by other companies].

Many funds that are originally small-cap funds turn into mid-caps or large-cap funds when they get larger. Acorn has managed to stay in the small-cap arena. How?

You've got to be careful, because if you're successful running small caps, your fund automatically grows toward a mid-cap fund, so you've got to actively cut back the mid-caps to stay in the small-cap group.

Every few years we do a major round of what we call 'smallification.' We did that a couple of years ago—we deliberately sold a number of stocks that had appreciated into mid-cap territory, and we reinvested in small-caps. It was relatively easy to do at that time because small-caps were so much cheaper. When we did a mini-round more recently, it was tougher to do. Now, we're not going to do it just to fit into some evaluation service's style box, but we are going to do it if it makes sense for shareholders.

It must be a difficult decision, because if your small-cap has grown into a mid-cap but is still growing, you are selling your winners. How do you do it?

Once a stock is over $2 billion cap, it warrants increased scrutiny where we look much closer at its valuation and its fundamentals—in other words, it's on a watch list.

There are times, too, when companies get tired. They get to be very successful and they get into mid-cap territory and they've already gained their market share—their underlying market or industry is slowing down or something like that. You've got to watch your fundamentals as well as valuations.

Acorn has done tremendously well over the long term—not only in terms of absolute returns, but on a risk-adjusted basis as well. How have you managed the risk?

Part of it is through our research database, where we have risk categories and we require higher returns for the riskier stocks.

Another is basically our personality. There was an easy way to make money a couple of years ago—Alfred E. Newman could have made a lot of money in 1999 by taking enormous risk. We just said, "Hey, that's silly. You're going to get killed, although we don't know when, but we're not going to be in your boat." For us, that was an easy decision. Of course, you are always tempted because some 25-year-old kid outperforms you for two or three years. But why wreck a long-term record? We've been through cycles before. And there are a lot of shareholders who have been with us for a long time—we don't want to take that kind of risk.