AN EDUCATIONAL APPROACH TO INVESTING IN GROWTH COMPANIES

FUND FACTS

STEIN ROE YOUNG INVESTOR FUND—(SRYIX)

CATEGORY:
Growth

PERFORMANCE: (thru 3/31/00)

Compound Annual Return (%)	Fund	Category
1 Year	32.9	26.3
3 Years	31.1	22.5
5 Years	30.7	21.7

RISK: (relative to category)
Above Average

TOTAL ASSETS: (as of 3/31/00)
$1.5 billion

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Many mutual funds attempt to educate their shareholders about investing so they can better understand fund management and performance. But most mutual funds are marketed for adults, with shareholder education aimed at an adult audience.

The Stein Roe Young Investor Fund, though, has taken aim at the growing market for young investors—investments that can be purchased by parents and relatives for children as both an investment and an attempt to help educate them about investing.

Can a fund aimed at young shareholders compete successfully with its adult-oriented counterparts?

So far, the results are promising. The Stein Roe Young Investor Fund has managed to perform quite well relative to other growth funds, earning itself an overall five-star rating from Morningstar. It has outperformed the average growth fund for the last year, three years and five years, and it has been among the top 20% of all growth funds for the last three and five years (as of March 31). Currently, it has about $1.5 billion in total assets.

In early April, portfolio manager David Brady discussed the management of the fund with Maria Crawford Scott.

What's the investment objective of the fund?

The objective of the fund is twofold. The first is to produce superior long-term investment results for our shareholders, and the second is to educate our shareholders about money and investing.

In terms of our investment philosophy, we believe in buying outstanding companies that can grow sales and increase earnings power over time. The reason that is important is because we believe that stock prices will follow growth in earnings per share over time. We try to put together a portfolio of companies that can grow sales at 15% and earnings per share at 17% annually over the next three years. We tend to keep the portfolio concentrated—we're typically only going to have about 55 names in it, versus maybe 130 for the typical mutual fund.

Also, we diversify the portfolio in a number of different ways. For instance, we have a portfolio that's usually about 60% in large-cap, high-quality growth names, and the rest is in medium- and small-sized companies that are typically faster growing. The small- and mid-cap exposure adds volatility at any given point in time, but we feel that the superior growth prospects add return potential to the portfolio and that our shareholders who stick around for the long term will be more than paid for the added risk that they are taking on.

We are very aware of our shareholder base. About 70% of our shareholders are kids, and the typical shareholder is in about the sixth grade. Most adults are going to buy an aggressive growth fund and a value fund—they can diversify on their own. Kids really can't do that. So for most of our shareholders, this is the only investment they own. As a result, this portfolio has typically been very, very diverse, across market cap, across industries, and while every company in there is growing, not every company in there is an aggressive growth name. I do want some value names as well as some growth names. For instance, we have always owned financials, and there have always been basic materials companies.

How do you start your search for a stock?

In the search process, the first thing I do is to think about the world, how it's being shaped and where it's going. I try to identify sectors that are going to grow faster than the economy as a whole, and then I look for the best companies, small, medium and large, within those sectors.

The themes have been remarkably consistent for the last five or six years, and I think they will be much the same for the next 10 years. Technology clearly is the fastest growing sector of the economy, and I would expect it to remain so as companies spend to lower costs and improve productivity.

In the healthcare area, the aging of the baby boomers clearly creates a demand for pharmaceuticals and other healthcare products.

Financial services is another investment in the aging of the baby boomers. Deregulation in telecommunications clearly has spurred competition and created more services and more demand.

Another area that I like is the consumer sector. I think the economy's in great shape, it's growing wonderfully, and you've got a good chunk of the population in the 40- to 50-year-old range where you spend a lot of money. So I look for investments in that area. The radio sector has been very good to us.

How do you find the "best" companies within each sector?

Typically that's a statistical screening—who's growing the fastest, who's growing their earnings per share the fastest, which companies have the greatest earnings stability—factors along those lines.

The next step is to do the fundamental research—to dig into the company, understand management, get a feel for the future prospects of the business.

Lastly, we look at the stock itself. We forecast earnings and we predict stock prices out three years based on middle-, worst- and best-case scenarios. I'll compare those prices to today's price. I have to believe if I buy the stock today, I will be rewarded enough to compensate me for the amount of risk that I'm taking for holding that stock over a three-year period.

For instance, a 40% return would be fabulous for a company like McDonald's, because McDonald's has outstanding management, they grow, consumers are going to eat there for a long time—the business characteristics just aren't very risky. But a company in the technology area that is in a competitive and rapidly growing market—if it came up with a 40% return over the next three years, I probably would say that's not enough. I would need a 60% or 70% expected rate of return in order to compensate for the amount of risk that I'm taking.

Basically, we try to hold great companies in the fastest growing sectors that we believe are also going to be good stocks—that's how the process works.

Would you characterize your strategy as more growth-oriented or value-oriented?

My strategy is very broad, I can take this fund anywhere. If we were getting into a value type of market, I could use my same approach to pick what other people would call value stocks.

The way I look at the world, there is an element of value in every single company I own, and that goes for Cisco all the way down to Texas Regional Bank Shares, which sells at a price-earnings multiple of 10. The element of value is the fact that I expect to earn a return over the next three years that will more than compensate me for the amount of risk that I've taken. It doesn't mean it's got a low price-to-book ratio or a low price-to-sales ratio or anything else like that. It means, here's a company that is growing and I'm going to make money on a risk-adjusted basis. That's the element of value that I look for.

You said that your second objective is education, primarily for "young investors." Does that have any impact on your selection of stocks?

It does in a way. We don't put tobacco or alcohol companies in the fund, or companies whose primary source of earnings comes from gambling. We have dropped those three areas. We try to focus on those companies that affect the lives of kids, or young people. At the fund's inception six or seven years ago, that was defined very narrowly, and companies like Coke and McDonald's, which are great companies, constituted an inordinate amount of the portfolio. My feeling, though, was to make it really educational and expand what we own. There are so many terrific companies out there that touch kids' lives either directly or indirectly that they don't even know about, and that they use just as much as they might use a McDonald's or a Coke. For example, Cisco Systems is a leader in the data networking business, a leading Internet infrastructure business. Not many kids had heard of Cisco until recently when they started their TV ad campaign. Most kids are fairly proficient on the Internet, and we described to kids, through our magazine, that when you hit 'enter' and the data shoots through your phone line and out the door, Cisco makes the routers that get the data to the right place at the right time. If you break it down that easily, I think kids can understand what a very topical and complex company can do. I felt that if we broadened the stock base, it would be a better fund because the returns would be better, and at the same time we would do a better job of accomplishing our educational objective.

You wouldn't buy Pokémon, for instance, just because it's popular among kids?

No, not at all. I get that question a lot. In fact, in the early stages of the fund, when people didn't really understand it, the question I'd get was: "The kids are managing this fund?" And I get questions about

Pokémon. But it's just the opposite. It's got to be a legitimate investment, otherwise it's a waste of everybody's time.

Do you invest in very many Internet-related companies?

Most of the dot-com companies are pieces of junk, and the answer is no. Many were just beneficiaries of being in the right place at the right time and having capital available to them. Any crazy idea can get off the ground as long as you call it dot-com, and most of those companies are going to be gone in the next year or two.

But I'm a huge believer in the Internet in general, and I've stuck to my guns in investing in the infrastructure—companies that are going to win no matter which dot-com companies survive. For instance, AOL has been a core holding, as has Cisco Systems.

What about initial public offerings?

No. We'll occasionally get involved in the IPO market, but it can't really help the fund very much because of the fund's size. The allocations of hot IPOs are so scarce typically and the valuations go up so quickly they can't help the fund significantly.

What would cause you to sell a stock?

If the fundamentals change substantially, we would sell it outright and get it out of the portfolio. For example, management could have changed, a new competitor may have entered the market, or I may have come to the conclusion that I made a mistake on my original assessment of the fundamentals or management isn't executing the way I had hoped. Those would be reasons for selling a stock.

What if a stock is doing particularly well—would you trim back?

I like to buy quality and let it run. But if it gets too large—for instance, I was a very early-stage investor in Cisco, it's been in the portfolio for four and a half years, and it got to be close to 5% of the fund. Although the growth rate has accelerated here recently, I don't expect that to last forever. I think the company's outstanding, and the fundamentals are outstanding, and I want to keep holding it, but I have trimmed it back.

How do you limit risk in the fund?

By constantly thinking about the world and how our companies will behave, understanding the companies that we own, staying on top of the fundamentals, keeping the portfolio diverse but concentrated in a number of names that we can really understand—that's pretty much how we do it. The portfolio turnover in this fund has been very low relative to most other funds. We buy stocks and hold onto them.

But the fund will be more volatile, though, than the Standard & Poor's 500?

I would expect it to be more volatile than an S&P index fund, but I also expect it to have more upside potential if you're patient. For instance, back in 1997 when small-cap stocks were really falling out of favor relative to large-cap stocks, our performance relative to the S&P didn't look so hot. But the message always was that we're going to do this because we believe in it, and it paid off really well last year.

How do you educate your shareholders?

When you sign up for the fund you get a welcome kit, which has pamphlets and documents that start with the very basics: what's money, what's a stock, what's a bond, what's an equity mutual fund, a fixed-income mutual fund, why you'd want to own or keep one over the other. The welcome kit is designed to help parents educate themselves very quickly on the basics and to help kids educate themselves as well.

We follow that up with a newsletter that we send out quarterly called the "Dollar Digest," written at about a sixth grade level, in which we talk about money topics of interest, such as how can you be successful if you start a lemonade stand or a lawn mowing business. We also talk about companies we own in the portfolio and why. In this upcoming issue, we are running an interview with Steve Case, the chairman of AOL. We asked kids in a prior issue to send in their questions, which they did, and they really asked some great questions, which we are publishing along with their names.

We also have a very good Web site that is kid-oriented.

How do you explain risk to your young investors? Do you think that they really understand it?

No. I don't think they do. It's a very difficult subject. We are constantly talking about risk, keeping portfolios diversified, reminding investors that stocks go down depending on the timing of any market correction. We try to show that just staying on course, buying high-quality companies and holding onto them will produce superior results over the long term. And I think most of our shareholders are focused on the long term.

Do you think they would hold through a prolonged down market?

I think the bulk of them would, although I'm not expecting a bear market at all. But I'd be willing to bet that the vast majority of our young investors would hang on for the long term. It's the professional money managers in the fund that say they're long term and really aren't—they tend to whip money around pretty fast, and I've never seen one of them that does it profitably. ◆