An Interview with David O. Nicholas, portfolio manager, Nicholas Limited Edition Fund

Searching the Small-Cap Market for Growth at a Reasonable Price

Small-cap stocks have not fared badly over the past several years. Nonetheless, they are being handily beaten in the performance race by their large-cap counterparts. Over the last three years (through September 30, 1996), the S&P 500 has returned 17.3% annually, compared to 12.7% annually for the Russell 2000; over the last year (through Sept 30), the S&P 500 is up 20.3% compared to 13.1% for the Russell 2000. Over the last five years, small-caps are slightly ahead, with a 15.7% annual return for the Russell 2000 compared to 15.2% for the S&P 500.

Of course, several individual small stock mutual funds have turned in performance records that are closer to the large-caps than the small -caps. The Nicholas Limited Edition Fund is one fund that has managed to do so without turning to the volatile technology sector for a boost. The fund has returned 25.4% over the last year, 16.4% annually for the last three years and 15.9% annually for the last five years (all for years ending September 30, 1996).

The fund currently has about $230 million in total assets.

In late November, portfolio manager David O. Nicholas discussed the management of the fund with Maria Crawford Scott.

What is the basic objective of the fund?

The basic objective is long-term growth, mainly with small companies.

How does it differ from the other Nicholas funds?

The basic difference is that the Limited has smaller companies in it, which are maybe a little bit more aggressive and grow a little bit faster than companies in the other funds. The basic approach to investing is the same—a long-term focus and buying good-quality companies with growth potential at a good value.

What is the size of the companies you tend to invest in?

The range starts around $100 million in market capitalization, although I think we have a few even smaller than that, and goes up to around $750 million. However, sometimes a company we hold will grow pretty rapidly, and we don't tend to sell if we continue to like the company and its fundamentals. So we do have some larger capitalization companies, up around $2 billion, for example. Also, sometimes if we get a buyout and we like the company that's buying our company, we'll hold on to that company, rather than sell and create a taxable distribution.

How do you select a stock? Do you start with a screening process?

No, we typically don't do screens—we don't find screens to be all that helpful. We have a research team here and do a lot of research. Our information comes from the companies that we follow and those that we already own, and from the brokerage community. So, it really comes from a multitude of sources.

How do you value a stock?

Because we are long-term focused, we're looking for companies that have a consistent growth pattern of around 15% to 20%.

Earnings growth?

Well, in revenues and earnings. And potentially faster than that. But those companies also need to show good return on capital, a fairly solid balance sheet with not a lot of debt, and a self-financing balance sheet in which a company can generate cash, hopefully even through a growth period. Then we look at the management—we want to make sure that we have high quality management with a proven track record.

And then we look at the market valuations, and typically we are looking for a price-earnings ratio that's in line with its growth rate—that's sort of our benchmark.

What ratios of price-earnings to growth do you like to see?

Well, for instance, if it's growing at 15%, we like to pay 15 times earnings for it, or less; if it's a 20% grower, we may pay up to 20 times earnings for it. That's sort of a "one times" ratio.

A lot of times, especially in the kind of market we have today

---

The Nicolas Limited Edition fund is part of the Nicholas family of funds, 700 N. Water St., Suite 1010, Milwaukee, Wisconsin 53202; 414/272-6133.

where everything is fairly high-priced, we have a tendency to buy things when either the industry is out-of-favor or a company is having what we consider to be a temporary slowdown.

Over what time period do you want to see steady growth?

I like to focus on five to 10 years. Our portfolio turnover ratio is extremely low, under 30% on average, which implies a fairly long-term holding period. And that's important for taxable investors. If you look at our returns on an aftertax basis, we really jump up in the performance rankings because our turnover is so low. It's a very tax-efficient fund. We want to buy companies that we can hold for five to 10 years.

How do you judge management?

That's certainly a qualitative issue, and something we focus on quite a bit. In general, we look at the historical record of the company, since usually there's a high correlation between companies that have performed well over time and good management. And we meet with the management to try to get to know how they operate and what their goals are. We're also definitely interested in managements that own a lot of stocks themselves, and also whether they're currently buying the stock—that's usually a pretty good indication that they feel their stock is at a very good price to buy.

Is there a particular problem evaluating the managements of smaller firms in that a good manager at one stage may not be suitable at a later stage?

Yes, that's always a concern when you're dealing with smaller companies. Sometimes the managements can take a company to a certain level, and that's it. We have to sort of feel that out. It's a qualitative issue. We look at experience, we look at where these managers have been in the past and what their history has been. That usually gives you a pretty good clue as to how they're going to handle things.

You mentioned that you have a tendency to buy industries that are out of favor. Do you tend to look in particular industries, then?

Yes. The psychology of the market will take an industry down for whatever reason and we'll have a tendency to look at that industry. We try to pick out one or two of the best companies in that industry that we feel have the greatest long-term potential, and then we'll research those companies. However, we stick to our style. Since we're long-term investors, we're not looking at cyclical companies. We want to see steady earnings growth, so even though a cyclical will be out of favor, we typically will not go and look at that area.

Does your style cause you to be concentrated in particular industries, and if so, do you take steps to try to limit that so you are more diversified?

I do look at that—I don't want to get too concentrated, but it's not a major focus. The major focus is the companies themselves, the valuation and the long-term appeal of each individual company. If you look at the portfolio, it does have heavy emphasis on healthcare issues, which tend to be non-cyclical, and a few other industries that are also non-cyclical. But, in general, it's not really that concentrated.

But no technology stocks?

No, not directly in technology. If you look at a Morningstar sheet, they list our technology holdings at about only 10%. But we invest more in technology in a different way. The technology that we own is through companies either using technology to benefit other companies, say, business services or consulting firms, or providing outsourcing for companies' computing needs.

What would prompt you to sell a stock?

There are really two different situations that might prompt a sale.

The first would be extreme overvaluation, and that's a hard thing to define. Generally, we don't like to sell stocks. If the fundamentals are good and things are working the way we expect them to work, then we don't like to sell because they're usually good companies. Now, companies can go into periods of overvaluation and we monitor that, and if it gets to be what we call an extreme overvaluation, then we will have to sell some of our holding.

And what do you consider extreme overvaluation?

Well, again, that's somewhat of a qualitative issue, but we look at the price-earnings ratio in relation to its growth rate, and we judge each stock on the basis of its own unique characteristics.

The other reason we would sell a stock is if we've made a mistake and identified a company that hasn't really lived up to our expectations—we were wrong about the management's ability, and we were wrong about the business itself. Usually, poor fundamentals signal a problem.

Would a falling share price be a concern?

That's obviously an indication of something going on and we definitely monitor those cases closely. But in that situation, you have to distinguish movement driven by psychology and movement driven by fundamental factors, primarily the company's earnings. In a lot of cases, movement is driven by psychology, and so we try to take advantage of those situations by buying those companies when they are down.

You have one or two holdings that appear to be ADRs [American depositary receipts, the shares of foreign companies listed on U.S. exchanges]—I'm looking at Asia Satellite, in particular. What prompted you to buy that?

We hold only a very few ADRs. Asia Satellite is kind of interesting. There's a case where our research in other areas led us to this company. In our large fund [Nicholas Fund], we have a position in Hughes Electronics, which among other things is a big satellite manufacturer, and is also in the business of satellite leasing. That's exactly what Asia Satellite does: They're using satellites to beam down telecommunications and television and radio broadcasting. It's a great business, especially in Asia where the telecommunications and television broadcasting infrastructure is not very good. Satellite is a very cost-effective means of getting that to the people. And, once you have a satellite up, it's a little bit of a monopoly business because there's not a lot of competition. So it has good growth potential and there's not a lot of worry about competition. You just collect the revenues. There aren't a lot of maintenance expenses to go along with it, so your cash is free cash. In that respect, it's just the type of thing we look for, although because it is outside of the U.S., it's a little bit different.

It must have had a low valuation for you to have picked it up—why was that?

I don't think people understand the satellite business all that well. We understand it because of our research of Hughes Electronics, and we got to know the satellite business very well. I don't think a lot of analysts cover satellite companies. It's a fairly new industry in terms of public markets—most satellites have been run by governments, and it has only been in the last five to 10 years that private companies have been putting up satellites and making real businesses out of it. And so there isn't a lot of coverage on the Street.

Another interesting holding of yours is International Speedway.

They run the Daytona 500. We bought stock in that company over five years ago and it's been a phenomenal stock for us—it's gone up around 10 times. But when we bought the company, there were no other public companies involved in auto racing, and while this company was, it was very, very small and it wasn't traded very well.

International Speedway runs NASCAR, the sanctioning body for these kinds of car races, and the growth has been phenomenal. The racing sport has become more and more mainstream. They have luxury boxes now in these things and it's becoming a big business just like all other sports. What's happened recently is the advertisers have really caught on to NASCAR as a form of advertising, so there has been a big increase in sponsorship—companies like McDonald's, Coke and Philip Morris see this as a way of advertising to a specific type of person. The other thing that's happened is that the increase in channel capacity due to cable and satellite television has created channels to broadcast the races. Especially in the last couple of years, there has been a very large increase in interest in this area and you've had two or three more companies that have actually gone public, so it's almost its own industry now.

Is the fund always fully invested?

Yes. We don't try to time the market. We are cognizant of where valuations are, but in general there are always opportunities to find something unique or out of favor, especially in the smaller cap area.

Why is the fund named "Limited Edition"?

The reason it was called the Limited Edition is because when we started the fund, we wanted to keep it small, so we limited the number of shares available for sale. We started at 10 million shares, and once we sold all those shares, the fund was closed and we didn't issue any new shares. Then, over time, we had redemptions to the point where we could re-sell those shares, and that's where we're at right now. We feel that there are about a million shares left to be sold and probably by the middle of next year those shares will be sold again, and then it'll be closed. At that point, the fund will get up to about $250 million, which is still a very manageable amount of money to manage with the style we have.

How do you view the current market situation?

The current market situation is, well, a little strange. The large-cap market is extremely high, but if you look at the divergence of performance that we've had this year, it's incredible. The Dow is up something like 25% this year, but the Russell 2000 index, which is more of a small-cap index, is not even up 10%. So, I feel currently there's a lot of interesting valuations in the small companies, even though the overall market looks very high.

What is the major risk that an investor in your fund would face?

In general, if you look at our fund, we outperform our competitors usually when there's a bear market or a down market, and we have a tendency to somewhat underperform when there's a straight-up bull market. So, in general, it's a more conservative small-cap fund than most. Of course, there is also the small-company risk—small companies are more risky than large companies because they're small, they may not have the ability to protect themselves from competition as well, that type of thing—more business risk. And there is market risk.

We try to manage market risk by buying companies that are out of favor, companies that have more value. And the business risk we manage by trying to buy high-quality companies that have some ability to protect themselves against competition, and usually that includes having very good management.