A SEARCH FOR GROWTH AMONG THE LARGE- AND MID-CAP STOCKS

FUND FACTS

FOUNDERS GROWTH

CATEGORY:
Growth

PERFORMANCE: (thru 3/31/98)

	Fund	Category
1 Year	42.9	41.5
3 Years	31.0	27.4
5 Years	22.8	19.1

RISK: (relative to category)
High

TOTAL ASSETS: (as of 5/30/98)
$2.2 billion

CONTACT:
Founders Funds
800/525-2440
www.founders.com

Mutual funds tend to be categorized based on the size of the companies in which they invest. But not all funds fit neatly into these categories.

One growth fund that has done well over the long term is the Founders Growth Fund, which focuses on both large-capitalization (price per share times number of common shares outstanding) and mid-cap stocks. The fund tends to shift its focus, depending in part on where the perceived growth is. Over the last five years, it has performed among the top 20% in its category, and it has performed above its peers over the last year and last three years.

In early June, portfolio manager Edward Keely discussed the management of the fund with Maria Crawford Scott.

What is the investment philosophy of the fund?

The Founders Growth Fund has been in existence since 1962, and I've been running it since the very end of 1993—four and a half years now.

As its name suggests, we search out growth stocks among the mid-cap and large-cap universe, so anything above $1 billion is large enough for me to look at. Our objective is to try to find companies that can grow their earnings on a consistent basis at 15% or better.

There are also a number of other things we seek. We want companies that grow earnings because they can grow sales through new products and new services. We want companies that have either a dominant market share in their businesses, or the chance to take a much greater market share because of new products or new services. We don't own a lot of second-tier companies—companies that don't have commanding leads in their market. Of course, we look very closely at the management team and how they are compensated, what incentives they have, how much stock they own personally in the company, and, of course, their track record.

Why do you focus on both large-cap and mid-cap stocks?

It gives us flexibility, so that in a market environment favoring mid-caps and small-caps, we can play to that to some degree, and in a market environment favoring large-caps, we can be more large-cap.

Basically, we go where the growth is, and in the middle of 1994 there was a dynamic shift in the growth rates of small, medium, and large companies. From about the second quarter of '94 to the end of '96, large-cap companies were growing their earnings per share anywhere from 15% to 22%, whereas the mid-caps and small-caps were growing at only half to one-third that rate. That's something I look at very closely. So, since the third or fourth quarter of '95, large-caps have been about 70% of the portfolio, whereas 12 months before that, it was more like 50%.

Was your move from mid-caps to large-caps based on a top-down view of the market, or was it simply that the faster-growing companies you were finding were mostly large-caps?

A little bit of both. I don't spend an enormous amount of time looking at the top-down picture, but what I've found is that you can have substantial periods of underperformance in a portfolio if you are not aware of what is going on at a macro level.

I look at the top-down picture to help make some decisions about sectors that I expect to be able to grow faster than the rest of the market. In addition, I study data from a couple of different sources that show how fast different capitalization sectors of the market are growing. Those sources help paint a picture for me of where the growth is coming from and where I need to be looking.

Of course, earnings growth rates aren't the only consideration—we also apply a risk factor to the ability of a company to meet our earnings expectations. As a result, right now I would much rather own large-cap companies even though they are now growing at moderate rates, because mid-cap companies have greater risk—growth mid-cap companies tend to have quite a bit of exposure to Asia. Of course, every stock is different, and we judge each one on its own merits.

Why are mid-caps more sensitive to Asia? I would have thought that the larger companies would be more vulnerable.

The companies that are capable of growing at fast rates in mid-cap land tend to be technology companies, and technology companies are highly leveraged to Asia, as a rule of thumb. That's an area I don't want any part of right now. My portfolio has been positioned that way since November, so it is fair to say that I avoided a lot of the ugliness in December. Of course, I didn't participate in the big rebound that happened in February and March, but I'm not sorry that I missed it because that market has now corrected substantially.

Is the risk factor that you apply an actual number—an adjustment you make to your earnings growth expectations—or is it more judgmental?

It is not something I can put a quantitative value on, and say the risk factor is 1 or 10 or something like that. It is based on my expertise in judging how difficult it is for a particular business to run in a particular kind of economic environment and what the challenges are that the company faces in order to keep its growth rate going. If a company just keeps doing the same thing over and over again, they are wildly successful at it, the economic backdrop is good, and the secular argument is good for the kinds of product that they are selling, then I might say that it is a very low-risk situation.

How do you judge a company's ability to grow earnings consistently?

When I say consistently, that means that I care about every single quarter of reported earnings. We spend a lot of time talking to companies before they report their quarterly earnings to make sure they are going to do what they are supposed to do, because we don't like to own companies that miss estimates.

When a company doesn't meet expectations, is it generally your fault or theirs?

A little bit of both. Some earnings expectation misses are not predictable—the information simply could not have been found to give you that conclusion. Others are entirely predictable and those are the ones I really beat myself up on, where I might have had the information and didn't use it properly. Those become what I call my signposts from lessons that I've learned. For example, some retailers we focused on for a long period of time were willing to talk to investors like me on a regular basis about how their monthly store sales were going. And I had a couple of these companies who made the decision that they were no longer going to discuss those monthly sales. That left me with little information from month to month on how their sales were going. That has now become a signpost—a sign that something is wrong with that company, and they are anticipating more difficult times ahead. It doesn't make it an automatic sell, but when I see it, I know I need to do some serious digging to make sure that I'm not about to have a company disappoint me.

What about valuations?

We have a spreadsheet matrix that shows a variety of valuation measures—price-earnings ratio, price-to-sales, price-to-cash flow. Those are the main ones, although we also have a few others. We'll look at each of those numbers relative to the company's history, its peer group, and the market itself. Those variables give us a fairly good idea of whether or not the stock is reasonably attractive on a historical basis. It also gives us downside and upside measures.

Based on those historical numbers and looking ahead 12 months from now, I basically look at what companies should be earning in June of 1999, and then I figure out what price-earnings multiple the stock will be selling at 12 months from now on those earnings estimates. That gives us a price target that determines the price appreciation potential.

One of our objectives that I didn't mention before is a minimum 20% appreciation potential between now and the next 12 months, because I could have a great company that grows its earnings consistently at 15% or more, but its current valuation suggests that the stock might not appreciate any more than the earnings growth rate, or maybe even less. The vast majority of the companies in my portfolio have a 25% to 35% upside potential in the next 12 months.

Does the price target become a sell signal?

No, because I get to keep moving the price target out every quarter, based on future earnings growth and the applicable multiple of earnings.

However, the complete answer to your question is that it depends on the stock. If it is a very high-quality company that consistently meets or beats expectations, it may be what I consider a core holding, which means that I probably just trade around the position—when it gets expensive I may trim back some, and when it gets cheap I may add back to it. But the stock may stay in there indefinitely. Microsoft is an example.

On the other hand, I may see a stock that I believe has exhausted all of the upside potential for the next 12 months because it is so fully priced. In that case, I'll sell the position outright.

What else would cause you to sell a stock?

An earnings disappointment, first and foremost. Another would be a significant diversion from what the company does—in other words, an acquisition that they make in a business that is totally unrelated. Another reason to sell would be if I felt a new product that was supposed to generate strong sales growth misfires. Basically, I sell if something happens to the catalysts within the company that I originally identified as a reason to own the stock.

Would an earnings disappointment cause you to sell the stock, or would you just put it on a watch?

Well, if it is after the fact, then I have to assess whether I want to own the stock based on its current price, knowing what I now know. Now, I'm sure you have heard it before, but I am a true believer in the cockroach theory of earnings estimates, and that means if there is one miss, then there are probably more to come. There is no hard and fast rule, but I would say that 90% of the time on an earnings disappointment we sell the stock. But remember, we try very hard to get out in front of them [before earnings are reported] if we can.

What about market sectors? Do you take positions that vary from the S&P 500?

Definitely. I am aware of what sectors make up the S&P because at the end of the day I'm competing against it. Both my strongest suit and my Achilles' heel are my sector weightings. What I mean by that is, if I've invested in certain stocks because they have better secular growth and they all tend to fall in the same sectors, then I'll be overweighting those sectors. That is my strong suit because I think I can pick good stocks. On the other hand, sectors go in and out of favor, and so if I substantially overweight a sector, I can have substantial underperformance. I'm usually pretty quick to sell to reduce exposure to a sector if the fundamental case is breaking down, but I'm also willing to sit through the normal market noise and market volatility. You can see that in technology, for example. I had around 35% of the portfolio in technology in 1994 and 1995, probably 25% in 1996, and by the middle of 1997 it was 23%. Technology is one of those core growth areas, but the growth is not there right now, so I'm not married to it. And for that reason, technology has been only about 11% of the portfolio since November of last year.

What area are you overweighting now?

The largest position is in financial services. That's very specific to a series of themes. It is somewhat top-down-related because of the way I looked at Asia and how it affected the U.S. economy, which was that it pushed down U.S. interest rates and that, in effect, allowed the U.S. consumer to be able to go out and borrow more money from credit card companies, buy a new house or perhaps refinance existing loans, and spend money on other things. All in all, it was a big benefit for most financial service companies because the consumer is happier and healthier and wealthier.

Pharmaceuticals are also overweighted, as are consumer products. Those companies in general have more exposure to Asia, but they have been able to become much more efficient over the last few years, so even though they are getting so-so top-line growth, they have strong bottom-line growth.

I notice you also have a fairly sizeable holding in Philip Morris.

I bought the stock a little over a year ago because of the anticipated settlement, and I thought the settlement would really unlock a lot of value because the stock back then was selling at a very reasonable multiple of earnings. It has pretty consistent earnings growth of 12% to 13%, so it doesn't quite meet my hurdle, but the valuation was compelling. I bought it at about 44 and it traded all the way down to 35 or 36. Today it closed at 39½. Right now, I'm looking for an exit opportunity because I'm afraid the settlement is not going to play out the way I hoped 12 months ago.

It is another lesson learned—another signpost. When you own stocks that are subject to the whims of politicians, you are taking enormous risk, so the valuation has to be very low for you to justify owning those stocks.

You mentioned that you also take a close look at management and their incentives. What in particular are you looking for?

Insider ownership—what kind of money they actually have committed themselves personally—and also how their options programs are structured. That is, are the objectives of the incentive programs shareholder-focused, or are they just easy lay-ups for the management team to accomplish so they can get rich while the stock price languishes? The important thing is that it doesn't give them the incentive to jam the stock price up in the short term with the result that it suffers in the long term. A good incentive program should have some sort of staggered price targets for the options over several years, so that the managers of the company are encouraged to stay and repeat the good performance. ◆