IN THE MID-CAP MARKET SECTOR: A SEARCH FOR QUALITY AND VALUE

FUND FACTS

ARIEL APPRECIATION FUND (CAAPX)

CATEGORY:
Growth

PERFORMANCE: (thru 6/31/98)

Compound Annual Return (%)	Fund	Category
1 Year	34.4	23.8
3 Years	29.2	24.1
5 Years	19.5	18.9

RISK:
Low

TOTAL ASSETS: (as of 9/98)
$200 million

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While the best returns in the last few years have come from the largest of the large-cap stocks, they haven't necessarily left all modest-sized stocks in the dust.

One fund that has had considerable success focusing on the mid caps is the Ariel Appreciation fund. The fund actually managed to outpace the S&P 500 over the last year (through July, with a return of 34.4% vs. the S&P's 30.1%). It has also been among the top 25% of its category for the most recent year and most recent three years, and it has outperformed the average for its category over the last five years.

In early September, portfolio manager Eric McKissack discussed the management of the fund with Maria Crawford Scott.

What is the investment philosophy of the Ariel Appreciation fund?

Basically, it is an outgrowth of what we've always done here at Ariel. As you probably know, our flagship fund, the Ariel Growth fund, is run by Ariel's founder, John Rogers. That fund was launched in 1986 and focuses primarily on small-cap stocks and some mid-cap stocks. The Appreciation fund was launched in late 1989 and focuses on mid-cap stocks.

As mid-cap value investors, we look for well-managed, financially strong companies that produce quality products or services. We also principally invest in companies that are in predictable and consistent industries, so you won't find a lot of aggressive growth or volatile industries in our portfolio. We generally avoid companies that are very cyclical, tied to a commodity cycle or that are in rapidly changing or emerging industries.

Do you limit the size of the companies you seek?

Yes, the principal market capitalization range in the prospectus is $200 million to $5 billion. Of course, we don't automatically sell our stocks when they reach the $5 billion target, and we have a small number that are over that, but the character of the portfolio and the vast majority of the stocks are in that range. In fact, our weighted market capitalization is around $2.4 billion, so we are truly a mid-cap portfolio by that measure.

Why do you prefer the mid-cap range?

We believe that our research process, which is one of the ways we distinguish ourselves from competitors, is best served by investing in companies that aren't so widely followed, or perhaps out-of-favor on Wall Street. We started out with that approach in the small-cap arena, but in the process we found there were companies that were a little larger, specifically in the mid-cap range, that met our criteria. When we launched this fund in 1989, there wasn't much interest in mid-cap stocks, and there weren't very many funds in that area. Recently, it has started to emerge as a separate category.

What we get with mid-cap stocks, in our view, are companies that are seasoned—they've gone through their initial stages, and yet in many cases they aren't so widely followed on Wall Street. To us, mid cap provides the best of both worlds—you get companies that are reasonably seasoned and experienced, and yet you can find those that aren't so efficiently priced because there is not as much of a following for them on Wall Street.

How do you select stocks initially—do you have a screening process?

We search for stocks in a couple of ways. We do use a computer screen as a back-up check. The analysts here read prolifically general interest, technical, trade, and financial publications, and those are resources for new ideas. We also receive Wall Street research, although we use that more as a check on our own findings as well as a basis for forming some of our contrarian opinions.

We also like to follow the example of some of the legendary investors that we admire, using our experiences personally to identify companies. For example, Specialty Equipment, which is one of our smaller-cap names owned in both the Ariel Growth and Ariel Appreciation funds, is a company we came to know from visiting McDonald's. Specialty isn't a household name, but their food equipment products are in every McDonald's. They make the freezer machines as well as the grills that are found in many McDonald's—the clam-shaped grills that cook burgers and more recently the McFlurry product, which is a product that mixes candy or other treats into soft-serve ice cream.

As I mentioned, we also read Wall Street research to find contrarian plays, and Allergan is a good example of a contrarian play on Wall Street research. It's a pharmaceutical company that has been around for awhile but was really out-of-favor among the drug stock analysts, who were focused on the very large and excellent companies in the industry. Allergan, a mid-cap name that hadn't put out very good earnings results, was ignored. We saw value in their brand names and their specialty niches, and we started buying in last year thinking that at some point, with the consolidation in the drug industry that has taken place, the market would eventually embrace them. A change in management at year-end 1997 has energized the company, and they've posted much better numbers than Wall Street expected over the last two quarters, so now Wall Street has become very interested. This year the stock is up 39% or so even after the strong market correction that we have seen in recent days.

What are the primary characteristics you seek when analyzing a stock?

We spend a lot of time getting to know the companies well. We closely examine product or service quality by using both our own experience and knowledge, and through industry contacts—we'll often talk to competitors or suppliers or customers of a target company to see if they check out. We believe that if you invest in companies that have good products and services, and that are led by good managers, over time they will tend to perform well and more consistently than companies that do not. Certainly companies that aren't necessarily the best can be very successful on a short-term basis. But we have a strong buy-and-hold bias that emphasizes long-term results, and we feel that product quality and good management is the key to long-term success within a company.

What about in terms of growth?

We do want companies that have some growth potential—we are not strictly buying companies that are pure asset plays, for example. That said, we are not necessarily looking for the super-fast-growing company because it is very hard to find those trading at the attractive valuation levels that we like. We do have a target—we want our companies to grow at least 12% each year over our holding period, so that would be better than the average S&P company and would leave out the very cyclical companies that may grow rapidly during part of the period but over a cycle would grow slower than that.

Of course, that's not a hard-and-fast rule. Sometimes we may buy a company because it is out-of-favor and it may be in the recovery mode, so it may not post that kind of growth right away. But we are using that as a yardstick, so that over our three- to five-year holding period, we want to see it grow, on average, 12% or better, so if we don't get there the first year, then we have to have a high degree of confidence that the company is going to be able to achieve that in subsequent years to offset a slower rate of growth in the first year.

What about valuations?

We use a couple of methodologies—actually three. We look at price-earnings ratios on a forward basis, so we are looking at earnings for the next four quarters. Also, we look at cash earnings—cash revenues plus amortization charges, and we add those back because we feel that those aren't real charges. So basically we are looking at the multiple on cash earnings, and typically we want companies that are selling at 13 times or less.

In addition, we also look at the private market value of the company, which we define as the price an independent third party would pay for the entire company. We use transactions in the industry as well as asset value—whatever the most appropriate valuation methodology is for that type of company.

The third valuation method looks at discounted cash flows, which is a sanity check for bad calculations. What that means is that we determine the cash the business is throwing off, and we subtract maintenance capital expenditures and the like—what we get is a free cash figure. And we project that out as a stream of cash coming in over future years, growing at a certain rate, but then discounted at a certain conservative rate to give us the present value of the business.

It appears from your holdings that you are willing to buy fairly sizable positions.

That's correct. We believe that fairly concentrated portfolios are the way to go, and in that sense we are a little different from some of the other mutual fund managers. We feel that the work we do on companies adds value and therefore we can benefit our shareholders best by really making decent-sized bets in the companies that we've gotten to know well, rather than trying to own 100 or 200 stocks and diminishing our knowledge of those companies by spreading ourselves around. That is something we have done as a firm since our inception.

I noticed that you also have holdings in T.Rowe Price.

Yes. I suppose it is like eating your own cooking, so to speak. Even though they are obviously a much, much larger and esteemed competitor, we like the characteristics of the money management business and do think it is a good business. That said, it is a business that is very much tied to the market, and so we have taken some profits there, recognizing that the psychology of it will probably cause it to perform less well in poor market environments.

Does your philosophy cause you to overweight particular industries?

We do keep the portfolio diversified in the sense that we are holding typically 40 to 45 stocks. And there is diversification in that mix, but at the same time we don't feel obliged to hold every industry—I mentioned that we prefer what we call consistent and predictable industries. Therefore, we're not going to have exposure to some of the areas of the market based on our personal bias toward relatively predictable results. There have been times when we missed out on some of the really strong rallies in the market, if certain sectors were in favor. For example, our limited technology exposure hurt us in 1995 when the tech stocks were so hot. Energy is an example of an area we're not involved with because of its commodity characteristics, so if that area were to get very hot, we would not have the exposure there. But we think that the kinds of companies we invest in tend to perform well and indeed outperform the broader market, so we are comfortable with the amount of diversification and industry exposure that we have.

What would cause you to sell a stock?

When we establish positions, we also establish sell targets, which are dynamic, so that as the companies report better earnings and their outlook improves, our targets move, too. As the multiples of those cash flows and earnings go up, we start to see stocks approach our target prices and that's when we sell. We initiate positions generally when companies are selling at 40% of private market value, and when the price approaches 100% of that value, we take profits and generally sell out of the position.

We will also sell if we made a mistake—if we realize that a company we've invested in isn't going to realize the goals and objectives the company set for itself. Of course, we won't sell on a small stumble. If a company is short a few pennies even though we see Wall Street being very short-term oriented, we try to take a longer view.

Also, if we see a significant change, we may sell. Significant changes include a major change in the market position or the entrance of a new competitor in the industry, and a change in management. Those are things that cause us to take a fresh look at the company.

Do you do any type of market timing?

No, we don't. We feel that it is our responsibility to stay fully invested in the style that we do. We leave the asset allocation decisions to our shareholders and customers.

What happens when market valuations are exceptionally high—do you adjust the valuation levels that you are willing to buy?

No. Typically, we would hold a little more cash, but not much. Usually, we hold 5% or less in cash. At the beginning of the year, when valuations were high, we were redeploying cash—reducing or selling positions in stocks that were hitting our sell targets, and then redeploying that cash into newer names, or cheaper names in the portfolio. We have always been able to find decent values.

Of course, the market wasn't really as high in the mid-cap area anyway.

That's right. That's an important point—many of the record-setting multiples were in a very narrow strata of the market, the mega-cap stocks. We saw some of that in a few of our companies, but we also had many that weren't really overly priced. They may not have been cheap, but we still felt comfortable with them as holds.

The large-cap segment has been doing better than either the small caps or mid caps in recent years. What do you think accounts for that, and do you see that turning around?

Without trying to predict any kind of timetable on that, we think you will see better performance from the small caps at some point. A lot of the conditions that led to outperformance of the mega caps are specific to this period. Many of the global money flows that were coming into the U.S. markets invested in the most liquid and larger names, and we think that impact will be diminished with the international problems that we're seeing. Also, the larger caps tend to be more globally oriented, and they are going to get some points shaved off of their earnings growth by the global problems. Conversely, many of the small- and mid-cap names have less foreign exposure, and we think that their growth rates on the whole will hold up relatively well, so even though we certainly haven't seen it yet, the stage is set for improved relative performance from the small caps and mid caps. One of the huge drivers in this market has been the flow of money from defined-contribution plans, and that flow of money is going to continue to flow into the marketplace for the foreseeable future. ✦