An Interview with Gerald J. Moran, portfolio manager, Scudder Global Discovery Fund

Seeking Growth Opportunities Among the Small Caps Worldwide

Small stocks have been the focus of considerable interest by individual investors for many years. And the international markets have drawn investor interest as investment horizons expand and world economies become more integrated. It is not surprising, then, that a number of funds have melded the two interests, setting their sights on smaller stocks worldwide.

One fund that has done well in this area is the Scudder Global Discovery Fund. It was among the top 25% of all international stock funds for the year (up 18.0%), three years (11.5% annually), and five years (12.7% annually) for the periods ending September 30, 1996. That compares with returns for the average international stock fund of 11.5% over one year, 8.9% annually over three years and 9.7% annually over five years; and returns for the MS EAFE index of 8.9% over one year, 8.3% annually over three years and 8.5% annually over five years.

The fund currently has about $365 million in total assets.

In mid-December, portfolio manager Gerald J. Moran discussed the management of the fund with Maria Crawford Scott.

What is the investment objective of the fund?

We're looking for superior and long-term capital growth by investing in smaller companies globally. That would include both developed and emerging markets.

Recently, the name was changed from Global Small Company to Global Discovery. Did you change the name because you changed your approach?

No, it did not reflect a shift in the way we invest at all, but rather we got into a semantic discussion as to what constitutes "small company." It's the process of growing large, when other large-cap investors want to buy these stocks, that delivers the return to our shareholders. In other words, if we succeed, we don't want to cut off the heads of our flowers. So, if some of our former small stocks are larger but still growing, we may want to keep holding the stock. The name change gives us a little more latitude to hold onto our winners.

What is the market capitalization range of the companies in which you invest?

According to our prospectus, we must keep the median market cap below $750 million, and, at any given time, two-thirds of the portfolio has to be below $2 billion. So there are plenty of constraints that we've placed on ourselves to make sure that we remain true to our mission.

Why are you a global fund rather than an international one—why include U.S. companies?

As the world and businesses become more global, artificial distinctions such as the domicile of the firm's headquarters are becoming less important. The important thing is that we look for world-class winners. I'll give you a couple of examples. One good one would be Central European Media, in which a major earning asset is the television station in Prague, which just recently got a grant for licenses in Poland, and which is in three or four other middle European countries. The company's major offices are in London, so it's classified as a U.K. stock. Similarly, Millicom spearheads the development of cellular telephone operations primarily in developing markets, but it's headquartered in Luxembourg. In the U.S., many of the semiconductor companies have more than half of their sales abroad.

Would you say, then, that you are looking primarily at global companies?

We're looking at companies that can dominate their markets and hopefully turn into global companies. We do have some local companies, such as Marschollek Lautenschlaeger, a German company. But we don't want to be constrained by what are proving to be increasingly artificial distinctions. National boundaries are giving way to market realities and I think that this fund recognizes that.

The prospectus emphasizes that the focus is on "superior companies." What are the things that you feel defines a superior company?

We focus on market leaders or market innovators and on the quality of management. We also look for a sound financial structure, and the issue there is that in the part of the market in which we invest, which is less liquid, there's no point in taking excess financial risk in addition to the corporate risk. We want to understand the business and its competitors, the competition being a critical element—again, it's a smaller

The Scudder Global Discovery fund is part of the Scudder family of funds, 2 International Place, Boston, Mass. 02110; 800/225-2470; http://funds.scudder.com.

part of the market, and, from a competitive standpoint, usually the market leader can maintain and expand its market leadership. There are also technical factors we examine that relate to whether it's a health company or a technology company or what have you. But if you had to narrow it down to three things, it would be management, management, and management.

In terms of management, we look primarily for focus, dedication, experience, and whether the management's view of what he or she is trying to do with the company meshes with our view of the realities in the competitive market. Managements that aren't terribly attractive are unfocused conglomerates; we prefer discernible lines of business, and the fewer, the better.

Within your investment universe, does "management" consist primarily of one person?

One of the aspects of small-company investing is that there's a greater tendency to have a single driver. Clearly, he or she is always backed by a good team. But more so than in large-cap investing, the analysis of the driving force of the company is critical to investment success. And one of the things we have to look at is whether the management is prepared to evolve to a structure that can handle a larger size. Clearly if a company's going multi-national or global in its workforce, it has to change from the way it managed when the firm was a small, one-country operation. We look at the ability of management to recognize what changes have to be made.

What fundamental features within a company are you looking for?

The sales and earnings growth rates that we typically look for are well above average—above 15% and in many cases they're above 20%. But we also look for the durability of the growth rate—is it a roman candle, or is it a fast-moving plane that will take you around the world for the rest of your life?

What kind of track record do you want to see in a company?

It differs between the U.S. and the rest of the world. The U.S. has a vibrant new issue market and the companies tend to be younger than they are in the rest of the world, where we typically look for refocused companies with extensive experience rather than new companies.

What about valuations?

Clearly we will not pay anything for growth. But, within that context, what we look for is delivered growth—that is, what are the chances that the company can actually grow at, say, 20% to 25% a year?

In many countries around the world, there's only a slight premium that has to be paid for those types of companies relative to the market, so typically excess valuations are not there for smaller companies. In those countries, large-cap stocks are considered the only place to be. So, all you have to do is be right on the earnings growth over the three- to five-year period and typically, in this capitalization range, this would produce excellent results relative to the averages.

How do you find your companies?

Scudder's been investing internationally since 1953, and we have a series of foreign funds that are more focused, including the Japan fund and the Argentina fund (a closed-end fund). So I draw on that expertise. We've been investing specifically in small stocks globally since 1989 and we've built up a watch list that we maintain and change using our in-house research analysts and our experience.

You mentioned that you look for market leaders. And, for instance, in Argentina you own Quilmes Industrial, which is a leading beer distributor. Are the companies you own "small" relative to their own markets, as well?

That's a good question. We're using U.S. standards with respect to size and in some cases—such as the smaller companies, Jeronimo Martins in Portugal, for example, or Quilmes and Siderca, which are two holdings in Argentina—the firms are substantial companies within their local markets. I think this approach makes sense because the alternative—buying only the small stocks in a small market—would preclude us from those small markets because of the low liquidity. In a small market, what would be defined as small would be the corner drugstore. So, it's very much a U.S. perspective with respect to small. What we really look for is the potential for growth.

Within the larger markets, for instance, Japan and Europe, would you be more likely to buy a small company relative to the local market?

Yes, although there is one distinctive difference between the U.S. and the rest of the world in the small-company area, and that is the percentage of ownership that "floats," that is available to public investors. That amount is less in the rest of the world, and particularly in Japan, and we sometimes find it necessary to go somewhat larger although remaining within the constraints we've placed on ourselves.

What kinds of political or macroeconomic trends would cause you to avoid investing in a country?

Our basic approach is bottom-up and we will not be scared out of a country because of a change in politics on a year-to-year basis. But we do look at the stability of the legal system within a country and its monetary structure. I'll give you an example: One of the concerns we have with respect to China is the amount of floating debt that exists in that country. Another good example would be Russia, where we are concerned about the law, since there's really no traditional case law on ownership. What you want to do is look beyond the economics of the country to find out whether the stocks held by outside investors are going to be treated in a fair and equitable manner.

Does your approach tend to result in concentrations in particular industries or sectors?

If you look at the statistics—the variability of returns of this fund—you will find that they're quite low. In our U.S. holdings, health and technology clearly stand out, but I think what distinguishes this portfolio is that we have deliberately tried to diversify the holdings so that they are not heavily oriented toward sector weightings in any one country. We look for areas of growth around the world with a focus outside the U.S., so that almost automatically produces a diversified portfolio and allows us to make some fairly significant individual stock bets without throwing off the risk characteristics of the fund.

What would prompt you to sell a stock?

Fundamental change would be the first reason for selling—meaning by frequency. In other words, the reason we purchased the stock is no longer the reason to hold it—for instance, an oil company goes into the electronics business, and you'd say that's loony, but I've seen a lot of strange things in my day.

The second reason we'd sell is that stronger ideas force out weaker ideas.

The third reason would be the ticking clock for successful stocks. We have a kick-out rule, and that means that once a company crashes through the $2.5 billion market-cap barrier, we put it on a ticking clock. Under normal circumstances, that stock would then be out of the fund within two years. That period allows us to collect the returns on the price appreciation, but at the same time, it forces us to get rid of the large companies.

The fourth reason is overvaluation. There are times, particularly in the new issue market in the U.S., when hype exceeds reality or expectations, and we would sell a stock then. But I will stress that it is not a major element and then, typically, relative price or relative performance forces us to ask the question, "Does the market know something that we don't know?"

Your portfolio turnover rates are quite low, implying at least a two- to three-year holding period.

We clearly buy with that holding period in mind for the bulk of our companies. And I can also tell you that the winners of last year, the top 10 stocks, constitute two-thirds of our profits and all of them have been in the portfolio since the beginning of the year. So we believe in putting the money behind the stocks that are in there and having a continuous analytical approach toward them.

What's your outlook?

We think the market in the U.S. is ahead of itself, and that international markets should be catching up somewhat. But, in general, we're more cautious on the market outlook for the next year. It's very hard to see a replication of the last year, especially in the large-cap market in the U.S., but I think small stocks and international stocks should do well.

Do you see any new areas opening up?

Well, I certainly hope so. We think that emerging markets are a tremendous opportunity for growth. The emerging market component of the Global Discovery fund is probably a little less than 10%, but it's probably two or three times that amount if you include the Millicoms that I talked about before— the companies that are located in one country and doing business in the developing markets. I believe half of Millicom's income comes from South America and Africa. We think that since the fall of the Berlin Wall, everybody's climbing aboard the bandwagon. And that's our approach to it—not so much 'this government has gotten religion,' but rather 'this company has business and has good prospects of getting more business regardless of where it is.'