A FOCUS ON LONG-TERM GROWTH FROM FIRMS WITH A COMPETITIVE ADVANTAGE

FUND FACTS

GABELLI GROWTH FUND

CATEGORY:
Growth

PERFORMANCE: (thru 3/31/98)

Compound Annual Return (%)	Fund	Category
1 Year	58.6	41.5
3 Years	34.0	27.4
5 Years	22.2	19.1

RISK: (relative to category)
Above Average

TOTAL ASSETS: (as of 3/98)
$1.4 billion

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The bull market has continued its stampede into the first quarter of 1998, and growth stocks have been leading the pack. While these stocks are often associated with smaller firms, it is the larger growth companies that have produced the larger gains.

One fund that has been very successful investing in the stocks of large growth companies is the Gabelli Growth Fund. In 1997, the fund was among the top five growth funds; it has performed above its peers over the last three and five years, as well.

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

What is the investment philosophy of the Gabelli Growth Fund?

The fund is a classic large-cap growth fund, where the primary emphasis is on finding companies that have the capability to grow their earnings at a 12% rate or better for at least a three-year period of time, and hopefully longer.

We seek genuine growth companies—firms that have some kind of a competitive advantage that sets them apart. That means they have to be in a value-added business, and then they have to distinguish themselves within that business.

There are several ways in which the companies we invest in have a competitive advantage. One would be companies that have proprietary products or services—for instance, companies with patented drugs or patented products.

A second competitive advantage common with our companies would be a dominant brand, such as Coca-Cola or Gillette, both of which dominate their markets.

A third kind of competitive advantage would be a company that has very little competition, and that can come about in several ways. Certain industries require licenses, and that limits competition. Cable TV is another example of limited competition. Limited competition could also occur in an industry that has gone through many years of consolidation, and what remains is an oligopoly or a near monopoly—a good example is the newspaper business in the major metropolitan areas in the U.S. Or, you may have a few competitors simply because the barriers to entry in the industry are very high.

There is a fourth kind of competitive advantage, and this one is more subjective and hard to identify: It is simply a case of great management. There are certain industries that are not particularly special, but where individual companies have shined for a number of years and that's because of great management. My favorite example here is the case of AIG, or American International Group, a large insurance company. The insurance industry has been one where companies have posted mediocre returns on average for a number of years. Yet AIG, one of the largest, has posted 15% growth for many years and continues to show no sign of doing less. That is truly exceptional, and it is because of management. Another example of the importance of management is in a company like Disney, which for a number of years was languishing, a fallen growth stock, until Michael Eisner and Frank Wells came along and turned it around.

How do you actually go about finding a company in which to invest?

It is a very undefined process. We have research analysts that will come to us with ideas; we go to conferences, visit companies, and sometimes simply by reading the daily newspapers and the financial press, we'll stumble into ideas.

One of the things that we try to do, once we think we have identified a company, is to ask ourselves if that company is a beneficiary of any kind of long-term trend. There are mega-trends that we think are very important and which influence our stock selection. Mega-trends provide a wind at a company's back.

For instance, one mega-trend is the aging of the population in the United States, Europe, and Japan. As the baby boomers age, their incomes are growing, their savings are growing, and they are investing more money for their retirement.

Another mega-trend we see is the whole notion, however vague, of globalization. Ninety-five percent of the people in the world live outside of the United States, and with the collapse of communism and the victory of capitalism, there are millions of new consumers and customers for U.S.-based companies. In many key industries, U.S. companies are in the number one position and in the best position to take advantage and, in a sense, exploit these new markets.

A third mega-trend, which is somewhat more difficult to invest in, is the whole technology and information revolution, whichever you prefer. The advances that are taking place in technology are changing the way we live and work and play. We invest in both the companies that produce the technology and the companies that use that technology to produce products better, faster, and with less inventory.

Once you have discovered a potential stock, do valuations play a role in your purchase decision?

Yes. We are not the kind of growth managers that will buy growth at any price. We are very much of the opinion that you can overpay for a stock. The valuation work we do can sometimes result in a portfolio that is somewhat conservative by growth-stock standards because we simply will not invest in companies that have exorbitant valuations and no earnings—most of the Internet retailers, for example.

What do you include in your valuations?

We take the company's current year earnings per share forecast, and project earnings per share in five years based on a five-year growth rate for that company. The growth rates that we use are not always the consensus growth rates, because I think on some companies they are too high—basically, anything greater than 20% or 22% is playing with fire because five years is a long time, and that is a pretty high hurdle rate for the large-cap companies we are interested in. Once we've projected earnings per share in five years, we discount it back to a present value figure, using a discount rate equal to the 10-year Treasury yield plus a 2% risk premium for equities. Currently, the number we use is 7¾%.

Once we've determined the present value of earnings five years from now, we multiply it by a "terminal multiple."

Is the terminal multiple your estimate of the price-earnings multiple five years from now?

Yes. In many cases, we'll take a 15% reduction from what the market is paying on today's earnings for a company. And we use no terminal multiples greater than 25, even for a stock that is selling at 48 times this year's earnings.

Once we apply the terminal multiple to the discounted five-year earnings figure, we get a price, and if that price exceeds the current stock price, then we feel we're being paid to own that stock. If that price is a big discount to the existing price—in other words, it is 15% to 20% below the existing stock price—then we would sell the stock if we own it because we don't feel we are being compensated enough to own that stock.

You are applying the valuation model to stocks you currently own, then, as well?

Yes. That being said, this is an art and not a science. The earnings valuation model is a tool, but it's not the decision maker, and it is imperfect. Earnings estimates are moving targets. Having used this kind of a model for a number of years, I know that there is a tendency where the stock's price will run up and, let's say it will look 10% to 15% too expensive, so you sell the stock, and then the company reports earnings that are better than expected. Then all the growth rate estimates go up, and when you run the numbers through the new model the stock no longer looks unattractive after you've already sold it. We do use human judgment to let our experience work to our benefit and not be too trigger-happy on selling stocks.

I should also point out, separate from the earnings valuation model, that when a stock reaches 30 times current year earnings, we will no longer put new money into that stock. Some would argue that these stocks can grow and grow and grow. But my contention is that in the large-cap universe, growth rates that are high enough to sustain multiples of 30 or greater can't last very long. There are almost no exceptions to this—and Microsoft can only be an exception for so long.

What other factors do you examine to make sure you've evaluated the stock properly?

There's a whole host of things that go into the evaluation of the company that will fall under the general heading of earnings quality. What appears as earnings growth in some instances is really more financial engineering than anything else. We try to avoid that. We try to emphasize companies that have good internal growth as opposed to acquisition growth—we really are not interested in buying companies that grow solely by acquisition. We are not interested in cost-cutting. We like our companies to make sure they are lean, but there are stocks out there where the primary engine of growth is simply cutting costs, and there is a real limit to how far you can take that. You need to have volume gains. Ideally, we have companies in which unit volume is growing and that have some pricing power but are not dependent on their pricing power.

IBM's growth in the last year has not been driven by unit volume growth; it has been growth by shrinking the number of shares outstanding, reducing the tax rate, and pulling out extraordinary gains here and there—it is very low-quality earnings growth.

Another thing we look at is the volatility of a company's earnings growth over time, and the less volatile a company's earnings growth has been, the greater the predictability in our earnings model as to what future earnings will be, and consequently, the higher the multiple that company will be accorded in the market. Wall Street does not like uncertainty, and so the companies that have the least uncertainty in their earnings stream are accorded the highest price-earnings ratios, and that is true in our model as well.

We look at balance sheets from the standpoint of wanting to avoid companies that have any kind of issues with the balance sheet at all.

When all is said and done, what we end up with is a portfolio of very high-quality companies that can weather virtually any kind of a downturn. They are the kinds of stocks that will certainly go down when the market goes down and will also come back when the market goes up, but they won't disappear from somebody's radar screen altogether. We take some comfort in that.

You mentioned your guidelines for selling when a stock becomes overvalued, but what about the downside—what would prompt you to sell a stock?

When a company has two consecutive quarterly earnings disappointments, that's generally a pretty bad signal and would prompt us to sell.

If we can detect any real slippage in the company's fundamentals, then we may want to sell the stock. For example, last year we sold Boeing because Boeing should have minted money last year. They had absolutely everything going for them—record orders, record backlog, huge worldwide demand—and what happened is that business was so good, they lost money. They were not prepared for the business that was coming in the door, even though I do believe they expected the business to be as strong as it was. I view that as analogous to a football team that has the ball on the one-yard line, first and goal, and they fumble the ball and lose the game. So I said to myself: We own Boeing precisely because, in a year like that, we expected them to make billions of dollars and share that with us, the shareholders, and instead they fumbled the ball. If that's what happens when business is really good, I don't think I want to be around when business is bad.

When the fundamentals change, then we have to revisit the company and really think hard about whether we want to continue to own it. However, in the kind of environment we've had in the last year, in most of the cases where we've reduced or sold holdings, it has been because they've run through the valuation targets.

You do tend to concentrate the portfolio to some extent in a limited number of stocks. Is that a risk to shareholders?

We are not playing the 'index-plus' game, which I'm afraid has become increasingly prevalent in our industry. Of course, people don't like surprises, and if somebody is hiring you to manage large-cap growth domestic equities, that's what they want—they don't want cash, they don't want small-cap, they don't want foreign, so you have to stick to your style box.

Well, we stick to our style box, but our portfolio will look quite a bit different from the S&P 500. We only tend to hold around 60 or 65 names, so there are at least 435 names in the S&P 500 that we don't own. Last summer, I felt stocks like GE and Procter and Gamble were too expensive based on the assumptions that we have for their growth rates, so we sold them completely from the portfolio because we believe that ultimately the numbers will run out. In fact, GE stock, since last summer when we sold it, has not outperformed the market.

In terms of risk, when someone invests in the Gabelli Growth Fund, they are going to get domestic large-cap growth, and they are going to have significant exposure to a handful of industries. There will be some industries where they have no exposure whatsoever. The primary risk they are taking is style risk—being in large-cap growth when large-cap growth is out of sync with the rest of the market.

Do you foresee a major drop in the stock market?

Well, I could certainly see the overall market backing up, when you think about what the market has done in the last three years and particularly during the first quarter of this year. Could the stock market go back down and give back everything it gained this quarter? Yes, absolutely. But I wouldn't consider that the end of the bull market. I just think at some point we are going to have to consolidate the gains that we've experienced over the last few years and experience some pain. I hope it doesn't happen, but I do expect it to happen. But when it happens is anybody's guess. I don't know. I don't have a clue.◆