SEARCHING FOR EARNINGS GROWTH: A TOP-DOWN, BOTTOM-UP BLENDED APPROACH

FUND FACTS

SIT LARGE CAP GROWTH FUND (SNIGX)

CATEGORY:
Growth & Income

PERFORMANCE: (thru 3/31/99)

Compound Annual Return (%)	Fund	Category
1 Year	21.1	4.7
3 Years	29.5	18.6
5 Years	26.2	18.4

RISK: (relative to category)
High

TOTAL ASSETS: (as of 3/31/99)
$130 million

CONTACT:
Sit Funds
800/332-5580
www.sitfunds.com

Comparing funds simply against their category peers doesn't always tell the whole performance story, as John Markese explains in his Mutual Funds article on page 14 of this issue. A fund's investment style and the size of companies in the portfolio make a difference, and peer comparisons in these classifications are also important.

One fund that has done very well relative to its peers in all of these classifications over the long term is the Sit Large Cap Growth Fund. The fund has performed among the top 25% of growth and income funds over the last year, three years, and five years (through March 31), and it has outperformed the average large-cap growth fund over those same time periods (for style and size performance averages, see the table on page 15).

In early May, portfolio manager Peter Mitchelson discussed the management of the fund with Maria Crawford Scott.

What is the investment objective of the fund?

The investment objective is long-term capital appreciation over time, with secondary emphasis on income generation.

This fund has had different names over the years, the one before this was Growth & Income Fund. What we found with dividend yields so reduced and with firms deciding to buy back stock instead of paying out dividends, was that it was increasingly difficult to put primary emphasis on income. So the fund eventually evolved with the marketplace and the companies we were investing in. Now, it is simply a large-cap growth fund.

What is the basic investment philosophy that you use in managing the fund?

We use the same philosophy and strategy across all of our equity products, and basically it starts with the presumption that above-average earnings growth is the preferred way to achieve above-average returns over the long term. It just makes common sense that if you can find industry sectors and companies that are growing faster than the economy, and if you apply disciplines on the pricing and valuations, you should be able to make very attractive returns over the long run.

We have two criteria for stocks in this fund, and growth is the first. The second criterion we use is the market capitalization (price per share times number of common shares outstanding)—we use around $2½ billion as a minimum. There are several names that are less than that, but by and large 90% of our stocks are at that size or higher. When you do those two screens, you wind up with several hundred companies. And from that, we use a group of analysts to do the industry research.

Do you have specific growth criteria?

Yes, when we say above-average earnings growth, we put a specific criterion on it that differentiates the different investment funds that we manage. For this particular fund, a large-cap product, we have a minimum projected earnings growth rate of 12% per annum. For our mid-cap fund, the minimum is 15% and for our small-cap fund, the minimum growth rate is 20%.

We also think that stability of earnings is a factor—we try to analyze that using earnings stability measures.

Another thing we use to help us make sure we have good growth companies is earnings revisions. We have our own model and we can basically screen thousands of different companies to see how the stock ranks on a scale of one to 10 on an earnings revision basis: Does it consistently come in above average expectations or not? Of course, if a company is not meeting earnings expectations and there is something going on, there can be an opportunity in those cases. But we have found that, historically, it's more often than not better to have stocks that are doing well on an earnings revision basis.

Once you've narrowed down the list to large-cap growth companies, how do you decide which ones to pick?

Well another thing that enters into the process is that because we're growth managers, we basically tend to look in the areas of the economy where there are attractive above-average, long-term secular growth rates. We have a system of categorizing the whole market into 17 different economic sectors, and you can see in which industry sectors there is growth. That will determine quite heavily where our analysts spend their time. And often, that top-down analysis confirms what we're finding when we do the screens for the companies. Typically, we'll overweight places in the economy where we see above-average growth prospects—for example, technology and healthcare. We also are overweighted in the financial area because we can find companies in that particular sector that meet the 12% earnings growth criterion, and they also have valuation measures that are quite a bit lower than some of these higher growth sectors. So we use that as an important balancing element in the portfolio.

We are typically underweighted in places where there is slow growth or cyclical growth, which means we usually have low weightings in utilities, and it would be very unusual for us to hold something that is purely cyclical, such as steels.

What kinds of companies are you looking for in the sectors that you wish to overweight?

They tend to be leaders in their industry groups. For instance, in the sector that we call electronic technology, which has a weighting in the S&P 500 of about 14.2% and in which we have about 23.8%, we hold such leaders as: Cisco, Sun Microsystems, Intel, Dell Computer, and Texas Instruments.

There is also another subdivision that we make in our portfolios. When we are looking at earnings growth rates of companies, we look at them in terms of three broad types of growth stock, which helps us to further strategize in terms of how the portfolio is weighted in different industries. Basically, we subdivide all the companies we own into conservative growth stocks; high and consistent growth companies; and cyclical, or opportunity companies.

This allows us to look at the portfolio purely from a top-down basis and determine where we are relative to the market. Right now, the earnings growth rates in our portfolio are high relative to the market—to put that number in context, the average projected five-year earnings growth rate of the stocks in this portfolio is 21.1%, while we project that the S&P 500 earnings are probably going to grow 8% to 10%, so we are very high relative to the market. And we are high because we emphasize that middle group—the high and consistent growth companies. At the end of April, the high and consistent growth area was 56% of our portfolio, while the conservative growth area was 13.9%, and the cyclical growth companies were 29.7%.

This subdivision also gives us flexibility to change the portfolio based on what might be developing in the economy or in the financial markets—say, for instance, if we want to get defensive. Of course, one of the things we can certainly do to get defensive is to raise cash, but historically we really haven't done that very much because we don't think that we are experts on making huge cash bets in the portfolio. We probably wouldn't go any higher than 20% cash, and in recent times we've been running the portfolio with basically minimal cash.

But a second thing we can do to get defensive is to strategically shift these big sectors around and increase our commitment to the conservative growth area, which is basically the financial stocks—things with lower price-earnings ratios and perhaps with higher yields. We also put asset-rich companies and energy into that group, although right now we hold very little in energy because we basically have been secular disinflationists at heart.

Right now, we are still of the view that the economy is going to be growing very satisfactorily in this country, and inflation, although it will be rising a little bit, probably won't get out of control. So we don't anticipate any major shift across these three categories over the near term.

I think this integration of the top-down and bottom-up approaches differentiates us from other funds. I would quickly add that it is three-quarters bottom-up versus one-quarter top-down, but we do integrate those two elements, we hope successfully.

Do you evaluate the conservative growth stocks in the same way as the high and consistent growth stocks?

Yes, we apply the same thought process even when we go to a slower growing area such as financial stocks. For instance, we own companies like American International Group, a global insurance company that has a very attractive growth rate and reasonable valuations, and a few other special insurance companies—basically we will try to find the growth vehicles within the industry groups that we decide to use.

Within the conservative growth group, what do you consider to be reasonable valuations and how do you balance the kind of growth you want with reasonable valuations?

One of the valuation measures that we find useful is nothing more than a relative price-earnings ratio history of the companies. For the big companies you can get those histories very readily, and we are able to go back and look at the 10-year relative [to the S&P 500] price-earnings ratio history. So one of the things we do is look at where the stock is trading now in terms of its historical valuation range. Now, you would expect that the really high growth companies would be in a higher range. But typically in the financial area, you can find stocks that are trading at the market multiple or at a little bit less than the market multiple. And we feel that the combination of a 13% to 15% earnings growth rate and valuations that are in line with the market multiple is very attractive. So that is how we go about doing it.

Now every single company is different. You can use all the basic statistical, quantitative, and analytical parts to do the best job you can, but in the end it comes down to judgment. And you might even find a company that is changing, or there could be something going on in the industry. One example is a company like Ceridian, which came out of the old Control Data—its relative price-earnings ratio history might be a lot different from what Control Data was back in its heyday because it is a totally different company. So, those are all judgments that our analysts must bring to a company when considering valuation ranges.

Do you have any valuation measures that you use on the high and consistent growers?

We use the same technique as the conservative growth stocks, but because the growth rate is higher, typically the absolute ratios that apply to each of these companies are higher. But we still look at the range—the 10-year historical range.

Of course, when the market has been as high-priced as it has recently, sometimes all of the stocks look to be at the upper-end of the range—so what do you do then? We take a portfolio view and look at how much historically people have paid for growth. For instance, the portfolio as of today has a price-earnings ratio of 29.5 (as of April 30) times calendar-year 2000 earnings, and the market base has a price-earnings ratio of 29 times our forecast for S&P earnings. Now, as I said earlier, we project the earnings growth for our companies over the next five years to be 21.1%, but our projection for the market earnings is 8%. So we're saying we can buy these companies at a price-earnings multiple of 1½ times the growth rate, while the overall market is priced at 3½ times—a much higher relative valuation.

We're still comfortable that inflation will stay under reasonable control, which gives us the confidence that these types of price-earnings multiples are not excessive given the economic framework that we are operating in.

What about mid-cap stocks? Doesn't the fund hold a few names in this area, as well?

The story on mid caps and small caps is quite interesting and perplexing. Our projections for their earnings growth rates are even higher than large-cap growth, and yet their multiples are much lower. We've felt for a couple of years that the mid and small caps look to be more attractive than the large caps. Now, this is primarily a large-cap fund, but we do have some of these mid-cap names in the portfolio. Currently, we have about 7% to 8% in mid caps—about a dozen names that were below $10 billion in market cap.

What would prompt you to sell shares?

We try to distinguish between company-specific items and strategic issues.

Earnings disappointment and deteriorating fundamentals are the key company-specific reasons we would consider selling, and any company-specific items that deal with disappointments that we know are dealt with very harshly in the marketplace.

The biggest reason, on a strategy basis, that would prompt a sale is deciding to make industry sector shifts, or macro issues that may change our perceptions as to growth in the various economic sectors. For instance, we just had an analyst in that was talking about the healthcare area and the possibility of a change in the system for Medicare. What we are concerned about is what that would mean in terms of pricing and other issues among our holdings. You only have to go back to 1993–1994 and recall the effect of healthcare reform proposals—the whole medical arena came down. And of course if we are going to make a shift or add something, you have to decide which stock to sell. That adds a certain amount of discipline to the process.

What about a stock that's had a huge run up in price?

Typically, we don't allow a stock to become greater than 5% of our portfolio. I often joke that if I held all the Microsoft that I've ever bought and never sold a share, it would it be worth 25% of our portfolio. But we want a diversified portfolio, so when a holding reaches the 5% level, we typically trim it.

We use all these tools to help us on the margin, but in the end, at least for the last several years or so, the turnover rates in this portfolio have been slightly below average. Month to month, there really aren't that many changes in the portfolio. It is really just a continuous process of trying to update the portfolio and making sure that it is optimum.✦