A QUALITY AND GROWTH FOCUS IN A VOLATILE MARKET ENVIRONMENT

FUND FACTS

NORTHERN SELECT EQUITY (NOEQX)

CATEGORY:
Aggressive Growth

PERFORMANCE: (thru 12/31/00)

Compound Annual Return (%)	Fund	Category
1 Year	–3.9	–3.7
3 Years	26.1	14.6
5 Years	26.3	14.3

RISK:
Below Average

TOTAL ASSETS: (as of 1/1/01)
$500 million

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It's hard to do consistently well while keeping risk in check when the market is all over the place, as has been the case recently. Not only has the overall market performed in a roller-coaster fashion, but the various market segments have shifted performance positions several times in recent years.

One fund that has managed the longer-term gyrations quite well is the Northern Select Equity fund. The fund outperformed the average aggressive growth fund for the last three and five years, while at the same time keeping a below-average risk profile. Currently, the fund has about $500 million in total assets.

In early January, fund manager Robert Streed discussed the approach he uses with Maria Crawford Scott.

What is the investment objective of the fund?

It's a large-cap growth fund, and what we try to do is to find larger companies that have superior quality and growth characteristics. We also want to find companies that have some kind of catalyst that is causing the business outlook to improve, and that could come from new products, new markets, cost-cutting measures, or maybe even the impact on the firm of changes in Federal Reserve policies and interest rates.

From that universe of fundamentally good companies, we choose the ones that the market is rewarding the best. We're not necessarily looking for the absolute best companies with the fastest earnings growth rates. For us, the fundamentals have to be good and improving. But we also want to keep an eye on what the market is rewarding.

What's the first step in terms of finding a stock? Do you start with a universe of particular stocks and then use screens?

We start with a pretty big universe: publicly traded companies with market capitalizations larger than $1 billion. And we look at that universe from a couple of different perspectives based on the characteristics that we want the portfolio to have, whether it's certain industries we want to emphasize or certain sizes of companies we prefer.

Our top-down view would cause us to look at certain groups and specific sectors. But we also will do screens to see which firms have improving or superior earnings and sales growth rates—basically bottom-up fundamental analysis. And, of course, there are plenty of anecdotal sources—we'll hear a story about a company, or a broker may tell us about a particular firm, and we would examine the company for that reason.

We also like to keep an eye on which stocks are performing best in the market, because if there is a stock, or more importantly a group of stocks, that's performing well and that's not something we've targeted, we want to find out what's going on—it could be an area that slipped through the cracks of our fundamental tests. Of course, we wouldn't buy just because a stock is going up relatively fast, but it's a flag telling us to do the fundamental work on it.

What data do you examine to determine performance relative to the market—relative strength?

That's one of the things we would look at. Also stocks making new highs and groups that have strong relative strength.

What do you look for in terms of growth?

What we look for most of the time is improvement and acceleration.

We want a company with a solid track record, and we look back three to five years because we don't want turnarounds or speculative companies. Then we'll go back three or four quarters and look for the improvement in business. What we're looking for is not so much the rate of earnings growth, or the level, but rather the improvement.

I will say that when you get into periods like we have now, where it's pretty obvious that earnings growth rates are slowing down, the term "superior" comes into play much more than "improving," and a "superior" rate is one in which earnings growth rates can simply be maintained—more of a stable company. Now, with the catalyst of the Fed easing interest rates, it's just a matter of time until that will lead to real improvement, so we will begin to look for those companies that have the business leverage to benefit once those Fed easings kick into the fundamentals of the company.

What kind of business leverage are you looking for?

It would be companies that tend to do better when consumption is improving because they are basically consumer companies—retailers in particular, such as Kohl's, that have gone through this business environment with relatively few problems, or retailers whose business problems occurred early when the Fed was tightening and the business has stabilized since then. It's going to be hard to spot that improvement over the next couple of quarters—in this environment, you have to look ahead a little bit. But there are certain businesses that have those characteristics of responding well to Fed easings.

This is an unusual situation—you don't go into these economic slowdowns too often. So most of the time, we would prefer to actually see the earnings results improving. In this case, we may have to anticipate it a little bit.

When the environment changes, then, you tend to restructure your portfolio to a certain extent?

As an example, let me go back and talk about the retailers. Retailing is a group that we've liked on a long-term basis. We began to pull back on the retailers about a year ago when it looked like the Fed tightening was going to take effect because we felt that consumption was going to impacted. Well, now consumption is being impacted, and the Fed is easing, so we know that consumption will come back, so we are going back and re-buying those retail stocks and building that position back up.

What about some of your other positions?

The areas we've cut back on are the deregulated utilities—the growth utilities, as well as energy, and some aerospace companies. That's all taken place within the past month, and actually I've had to step it up a little bit from last week because of the Fed's recent action—I thought I had time to make the shift, but that time frame has been accelerated.

Looking for growth can lead to risky portfolios, so you also must have other screens to help limit the risk. What kinds of protective screens do you have for the growth companies?

You're right. We look for balance sheet strength, the company's track record, whether or not there's been an earnings glitch in the past; we look at how the stock trades to see if the stock is one that has sharp drops in it. Basically, we focus the portfolio on companies with stronger balance sheets.

What we also do, though, is to keep an eye on the various risks we're taking in the portfolio. We don't necessarily have a black-and-white policy of avoiding one of those risks, but we want to monitor them so we know what kinds of risks we are taking in the portfolio. We may want a certain characteristic because we want to be different, and therefore riskier, than the market in a certain way. But we don't want to find out that we have exposure someplace that we didn't think we did.

What are the various risks you monitor?

In terms of company risk—for instance, if a company has blown up in the past—that's something that's taken into account early on as we're building our portfolio of strong companies.

With the portfolio, we look at things such as sector exposure, price-earnings and price-to-book multiples, whether or not the companies have strong earnings growth, foreign currency exposure, whether or not there are a bunch of stocks that have done very well and are therefore extended.

I should also mention market capitalization. We only deal with companies $1 billion or larger, and because we are a large-cap fund we try to keep about three-quarters of the value of the portfolio in stocks of $8 billion or larger. For a number of years, we tended to tilt the portfolio toward very large-cap companies—if we had a choice between two firms, we always bought the bigger one. However, beginning maybe a year or so ago, we took off that overlay, and now we feel the very large companies are the least attractive. So we are more favorable toward regular-sized companies and maybe have more mid-caps than normal.

So, at different points in time the portfolio has a somewhat different risk profile than the S&P 500?

Yes. The way you outperform is to be different than the market, and we realize that being different entails risk, so there are some risks and some differences we want to have in the portfolio.

Depending on market conditions, we will have a risk exposure that's different than the market's. For example, the one natural characteristic for us is to have a portfolio with a faster earnings growth rate than the S&P 500, and what goes along with that is a higher price-earnings multiple. Sometimes we'll go for *really* fast earnings growth rates, and sometimes we'll want to take the price earnings multiple down a little bit to reduce some of the risk in the portfolio. It's not a problem for us to be different. We just want to make sure we know where we're different.

Do your changes in emphasis come from a top-down view of the economy and market, or from fundamental evaluations of individual companies?

We look at it from both directions, and the times that it's most important to make a shift is when both of those directions click. For example, the Fed cuts rates, and the retailers do really well, so you have the confirmation of the top down from the bottom up, and you really need to make that switch.

Are valuations a consideration?

They are, but we use them primarily as a risk control—we want to see how much risk we are taking in the portfolio. We won't buy a stock just because it is cheap, and we won't sell it just because it is expensive. But we do realize that when a stock has a high price-earnings ratio, the volatility, and therefore the risk, is much higher. In that case, you really need to stay on top of the stock and give it fewer chances to disappoint.

When would you sell a stock?

One of the things that has helped us over the past couple of years are the sell rules we use.

When you get down to it, the whole idea of everything that we and other managers do is to own stocks that go up and outperform the market. On the buy side, we look for companies where the stocks are being rewarded by the market place. Now, if all of a sudden we own something that is no longer going up and outperforming the market, that's a cause for concern. At that point, we give it a hard look to see if we may want to sell it.

What measures specifically do you use to determine whether it is underperforming the market?

There are a couple of tests that I use. One test is if the market price is 10% from my purchase price. The second test examines trendlines. And the third test is a proprietary formula—basically, I look to see if a stock has dropped beyond an area where it began its last advance. Basically, there are three points that we can use. Of course, where you put the stop point is still a bit subjective, but if a stock falls below that stop point, it's a good reason to sell.

What about the up side? When would you sell a stock that has done well?

We would sell when it looks to us as though the run is over. I don't put target prices on stocks, and just because a stock is up or was a strong performer last year, that's not a reason to sell it. As long as the fundamentals are intact, and the stock is going up and outperforming the market, we'll stay with it.

The fund has a fairly high portfolio turnover. Is that likely to continue?

Probably. A reason for that is the sell points, and the market is so volatile that companies are more likely to trip those points now than they were in the past. It's higher than I want it to be, but we feel you're better off selling to maintain the principal in the portfolio.

Do changing themes also account for some of the portfolio turnover?

Some of it, yes. As an example, in 1999 it became pretty obvious that we wanted to be aggressive in technology—the strongest earnings growth and the best stock performance was there, so we were aggressive owners of technology names. When technology peaked and began to run afoul of our sell rules in the spring and early summer of last year, we were selling them and moving into other good companies where the fundamentals were improving but had been overlooked when everyone was focused on technology. After Labor Day, one of the biases we put in the portfolio was to have more companies with predictable earnings growth, because we suspected the economy was slowing and perhaps going into recession.

On the other hand, there's a certain core of companies that we have owned for many years—Walgreen's has been in the portfolio since the first day, and Kohl's has been in there for some time.

The fund has performed very well relative to similar funds. To what do you attribute that performance?

I think its because when we define the characteristics we want of the portfolio, it's in the fundamentals, and it's in the stock market performance. It's not necessarily in the tag or the name people put on the stock. For example, I don't care if I own a technology company or utility, or healthcare company. I don't care if it's a U.S. company or an ADR. But it has to have strong earnings and hopefully improving earnings, and the stock has to be responding well in the market.

The idea is to focus on these growth characteristics and realize that it may mean you have to go into a different stock or different segment of the market to maintain those characteristics. We're willing to do that. ✦