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Real Growth Stocks Can Outperform

In our last letter we discussed a recent study we did on the stocks in the current Russell 3000 to see how many companies actually had been able to achieve the Holy Grail of growth stock investors. That is, how many companies grew their earnings at a compounded rate of at least 10% for the ten years ending 2002, and experienced no years where earnings were lower than the prior year. Less than 4%, or 111 companies, met the criteria. And only 17 of them would have qualified as large capitalization companies ten years ago.

The list of these 17 companies and the investment return of each is shown below.

COMPANY	TICKER	CUMULATIVE RETURN 10 YEARS	ANNUALIZED RETURN 10 YEARS
Abbott Labs	ABT	219.35%	12.30%
Amer Int'l Group	AIG	338.12%	17.17%
Amgen	AMGN	447.58%	18.52%
Fannie Mae	FNM	313.94%	15.26%
Fifth Third Bancorp	FITB	549.75%	20.57%
First Data	FDC	317.00%	15.35%
Freddie Mac	FRE	462.43%	18.84%
General Electric	GE	318.49%	15.38%
Home Depot	HD	121.77%	8.29%
Johnson & Johnson	JNJ	398.98%	17.43%
Marsh & McLennan	MMC	299.47%	14.85%
McGraw-Hill	MHP	401.15%	17.48%
Merck & Co.	MRK	226.80%	12.56%
Procter & Gamble	PG	289.06%	14.54%
Wal-Mart Stores	WMT	235.45%	12.86%
Walgreen's	WAG	488.53%	19.38%
Wrigley (WM) Jr.	WWY	306.54%	15.05%
Equal Weighted Portfolio		340.24%	15.97%
S&P 500	SPX	144.16%	9.32%

It can be concluded from this chart that large cap companies which actually achieve Grail-like earnings trends can substantially outperform the market over time. It is also revealing to look at the list and try to think of what characteristics may be consistent with the achievement of high and consistent earnings growth.

First, it is obvious that no technology companies made the list, but five financial service companies did. This is notable in light of the fact that the Russell 1000 Growth Index, which most consultants use as a benchmark for growth managers, was close to two-thirds technology stocks a few years ago and had a tiny percentage in financials.

Second, Fannie Mae and Freddie Mac enjoy a virtual monopoly in the mortgage business as they have lower costs of borrowing due to their quasi-governmental status. Their shareholders have been well rewarded as the managements of these companies have exploited this monopoly quite well. Now that they have 90% of the mortgage business, it will be interesting to see if they can grow consistently for the next ten years. The other virtual monopoly is Wrigley, which owns the chewing gum business. Good cost controls and pricing power are a magic combination for sustainable earnings growth.

The remaining companies have one basic thing in common: they reinvent themselves. Consider drug companies. They constantly spend tremendous sums on research to find new products to replace and even cannibalize their existing products. This is also true of Procter & Gamble. Others on the list continue to reinvent themselves through management reorganizations or acquisitions and divestitures such as General Electric, First Data, American International Group, and Marsh & McLennan. Even the retailers Wal-Mart and Walgreen's have succeeded by reinvention. Walgreen's does it by constantly updating the real estate footprint of its stores. Wal-Mart did it by creating new, more efficient formats such as their now ubiquitous super centers.

It is not a coincidence that the one stock on the list that underperformed the market is Home Depot, which has been unsuccessful in its efforts to reinvent. After over thirty years in this business I can think of a long list of former growth stock icons which failed in this regard. How about Eastman Kodak, Xerox, Kmart, Gillette, Disney, Digital Equipment, etc.? I could go on.

So perhaps the most important research task for a growth manager is to constantly assess the expected growth of the companies in his universe. Where is it coming from? Is it sustainable? Are they investing in reinventing the company? Not watching closely can lead to disappointment. And in high-expectation stocks like these, disappointment can quickly become disaster.

The equity market has enjoyed a wonderful run since the depressed levels of March. Earnings reports have generally been better than expected and liquidity is high. Interest rates are surprisingly low and not likely to rise significantly. The change in dividend and capital gains taxation is a wonderful boost. We still believe the market can do well over the next twelve months as the economy picks up in the Presidential election year.

The one negative is sentiment. Currently, the Investor Intelligence Survey reports over 60% Bulls and only 16% Bears. These are extreme levels. We would not be surprised if a short term correction of 5-10% occurred over the next few weeks. At this point we cannot see anything more serious than that.

-Robert C. Davis, CFA
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A copy of our Form ADV, Part II is available upon request.
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