Going for the Good Growth

John Heffern and Marshall Bassett run the Delaware American Services Fund with the belief that a good stock picker can spot a solid grower regardless of the valuation or the market's latest flirtation with a particular sector. Heffern told Ticker how and why their fund remained in the top fifth of its peer group, beat the market handily, and did it without any exposure to tech and telecom.

Delaware American Services A		
Fund Facts		
Symbol	DASAX	
Website	www.delawarefunds.com	
Address	Delaware Management Company, One Commerce Square, 2005 Market Street Philadelphia, PA 19103-3682	
Tel. No.	800-523-1918	
Inception	12/28/99	
Portfolio		
Total Net Assets *		$18.60
Avg Mkt Cap ($ Weighted) *		---
Average Price/Earnings Ratio		---
Average Price/Book Ratio		---
Turnover Ratio		311%
Investment Information		
New Investment		Open
Min Initial Investment		$1,000
Min Subsequent Investment		$100
Min Initial IRA Investment		$250
Risk (Against S&P 500 - 3 Years)		
Alpha		1.8074
Beta		0.8897
R-Squared		0.7778
Returns vs. S&P MidCap 400 IX Tr		
	DASAX	Index
1 Year (Cum.)	40.43%	27.89%
3 Year (Ann.)	17.87%	6.85%
5 Year (Ann.)	---	11.36%
Returns vs. S&P 500		
	DASAX	Index
1 Year (Cum.)	40.43%	15.09%
3 Year (Ann.)	17.87%	-5.52%
5 Year (Ann.)	---	-0.47%
Fees and Expenses		
Max Sales Charge - Front		5.75%
Max Sales Charge - Deferred		0.00%
Max Redemption Fee		0.00%
Total Expense Ratio		1.22%
Portfolio Manager		
Management Team		---
* millions		Data through: 11/30/03
Source: Company Documents; Lipper		

Q: What was the idea behind that particular portfolio and what was its evolution?

A: The growth investment team, for which I work, has been in place since about 1997. It took over for the previous managers and implemented a very sector-oriented, fundamentally-based investment management process covering growth stocks and focusing on the main engines of growth in the economy:, technology, healthcare, consumer and retail, and financial services.

By the end of 1999, we were successful with small-cap, mid-cap, and large-cap growth investing, but we also recognized that we had within the group a certain sector expertise. It focused on the fact that there has been a strong shift in the economy from manufacturing to service-oriented employment.

So, our sense was that there was an investment opportunity not just in people who make widgets, but people who help widget-makers become more efficient, more productive, and provide services around all of the products that the economy might produce.

Q: Did you have some kind of a rigid breakdown of the service sector, or you rotate somehow?

A: We are pretty flexible from that perspective. But basically, we own a lot of financial services companies - that is probably the principal weighting and then we are significantly invested in retail and consumer services. We also own, for example, a company that produces scales and weighing instruments. That is the widget. But they also attach software to the scale, giving you aggregate statistics and information about the thing being weighed - whether is cereal or pills. That is the service.

Q: That is Mettler-Toledo, right, the Swiss company?

A: Yes. But they have significant sales and operation here in the U.S. And this is the other part of what we do - not just to focus on pure service companies, but to be committed to owning quality companies that are well-managed and properly run. Mettler-Toledo is a perfect example of that.

Q: You own a lot of financial services, and still you identify yourself as a growth investor. Isn't there a discrepancy of a sort?

A: We do not necessarily agree with other people's definitions of where things should fall. We buy growth wherever we find growth, no matter how others define their own universes. And clearly, if you just look at the numbers, financial services com-

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panies have produced earnings growth far greater than that of the economy overall in the last three to five years.

Q: Can you elaborate a little bit on your research and stock-picking process?

A: I think the simplest explanation is that we are really traditional stock pickers. And we go one by one, from the bottom-up. It is a very labor-intensive process. We start with the basic screen of companies that are growing faster than the market and then, within their industry sectors, those that are growing faster than their industries overall. And then we just begin to pick them apart, one by one, with a lot of research intensity looking at a company, its positioning, its market, the products that it offers, its margins, its management, its infrastructure. And then probably the last thing we do is apply valuation metrics to the investment process. We believe that companies that are growing sustainably fast are rarely overvalued, and companies that are growing slowly are rarely valued at a sufficient discount.

So, if we find the right company, one that is well-managed, in the right place, selling more products to more people at healthy margins, valuation is the last thing we look at. And with valuation, we tend to be a bit more generous in our view of what that company might be worth. That is our basic process - we just do it one at a time, every day, day in and day out.

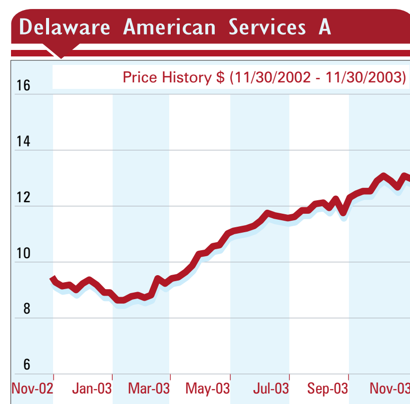
Q: You said growing faster than the overall economy. What do you take as the rate for the overall economy?

A: Mostly we focus on the Russell growth indices to get a sense of market growth. You can also look at the growth in the S&P earnings as another point of comparison.

Q: Do you have any capitalization restrictions?

A: There are no capitalization restrictions. We can buy large cap, mid cap, small cap, even micro-cap. I think the difference with us is that we focus on the quality of the company and the management team and the adequacy of infrastructure, because we like to hold our investments as long as possible. Many little companies tend to bet on a specific product that is untested, and are run by a management team that is unproven. The American Services Fund is currently centered on the mid-cap range, where companies are sufficiently developed and yet not overly mature. It is kind of a sweet spot.

The other thing to keep in mind is that we are not looking for hyper growth, because in our view hyper growth can carry its own set of risks. We think that if we find moderate growth - something on the order of 15% to 20%, and that compounds itself over a number of years, we will be successful. And if we avoid hyper growth, which tends to result in hyper explosions, it allows us to manage risk. We are looking for companies where we think growth can be sustained in the 15% to 20% range.



Q: You said you like to hold them. What does it mean in terms of turnover?

A: Our turnover is probably running in the low 100% right now, which I think is about normal for a growth fund. We have a core group of companies which we buy and hold, and then around the edges, we have the flexibility to look for short-term market opportunities.

Over the course of time we have exploited opportunities in insurance. We had some insurance exposure prior to the tragic events of September 11, 2001, but then insurance stocks were hit, in light of the enormous insured losses. However, that presented an investment opportunity in the market, with the accelerating pricing trends in the insurance business, and we took advantage of that.

Another example is that at one time we had a significant weighting in homebuilders. We continue to own some homebuilders that are doing well, but we also took profits along the way. That was a clear investment opportunity, also resulting from some price weakness around the time of September 11.

Q: This year we had quite a run in the market. What did it mean for your portfolio?

A: We are up over 40%. I think it is a competitive return on its own. And more important is the fact that we have accomplished that without any technology exposure. No Internet stocks, no chip makers, no telecom. We just don't participate in those areas. So, I think our returns over time have been remarkable on an absolute basis and remarkable for being accomplished without exposure to more volatile sectors.

We are convinced that within a limited group of sectors, and even excluding an important sector like technology, we can find stocks that will appreciate in value. It is back to the simple construct of selling more products to more customers at the right margin and being able to sustain it. I have been in this business for more than 15 years, and the basic notion of finding 15% to 20% growers, letting them work over time, and then adding on short-term trading opportunities, is more than sufficient to generate the kinds of gains we seek.

Q: And which stocks helped you do it?

A: As of November 31, 2003, we had at least six stocks that have produced more than 100% returns this year, none of which were technology. And we had many stocks that were giving us returns in the range between 20% and 70%. I think our most signif-

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icant loss is about 30%. Most of our losses have been bunched around the 10% to 15% range. We are pretty quick to recognize problems as well as opportunities. We don't want a fund that is comprised of problems. We establish a set of expectations for our companies. And if we see performance that deviates from those expectations, we have to shoot first and ask questions later.

Q: What is the sell trigger, then?

A: At the end of the day we are looking at revenue, margins, and earnings per share. If we are disappointed on any of those, we don't automatically blow something out, but we take a look at it are very stingy giving companies the benefit of the doubt. If we see a miss on revenue, a miss on margins, a miss on earnings, we'll look at it, we'll understand the explanation and if it is insufficient, we'll just sell it and get on with our lives.

Q: And how long after the conference call will that happen?

A: That can happen right away. We don't brood over these things.

Q: Which of your best-performing stocks you still hold?

A: My colleague, Marshall Bassett, owns Coach, the leather goods retailer, and we have done well with that. We own Sovereign Bancorp and it has performed well also. We continue to own the homebuilder D. R. Horton. Comcast is our largest holding. We really haven't done especially well with that. Our position is up about 10% or so, but that is something we continue to hold as a core position.

Q: I saw Cox is also one of your largest holdings. How did you choose those two - Comcast and Cox?

A: Comcast was for its size and its ability to leverage size in the cable business and the impact that will have on margins and profitability. And Cox - perhaps the Comcast guys would disagree - is the best-managed company in this space. They have just done a fabulous job, albeit with a smaller footprint. And to the extent there is an opportunity in IP telephony, I think Cox has done well there in some of its test markets and we think that can produce good growth on its own. It was understanding the differences between the two and we sensed that we could make money on them both.

Q: Do you play the consolidation drive, say in financial services, or you focus more on the organic growth?

John A. Heffern joined Delaware in 1997. He previously was a senior vice president, Equity Research at NatWest Markets, responsible for specialty financial services equity research. Before that, he was a principal and senior regional bank analyst at Alex. Brown & Sons. John runs the American Services portfolio together with Marshall T. Bassett, who is a former vice president in Morgan Stanley Asset Management's Emerging Growth Group, where he analyzed small growth companies. Before that, Bassett was a trust officer at Sovran Bank and Trust Company.

A: Everything we have invested in has always been for the organic opportunity. And we always viewed consolidation activity as additive, but not necessary. It is just nice to have that in the background. The fact of the matter is that financial services have been consolidating and we believe will consolidate forever, but that means two things - the big get bigger, the middle sort of get squeezed out. And they are always making new small companies that are hoping to become big.

So, I think we can pick our way through. We own Citigroup, for example, but we also own a company called RAIT Investment Trust, which is a small financial services company in Philadelphia, investing in commercial real estate. I am convinced we can sort through these areas, find good companies at the right time and the right cycle, and I think the same my partner will say holds true for specialty retail. There are big retailers, but there are also small retail companies coming along. There are restaurant conglomerates, and there are also specialty restaurants that we can invest in. They may give you a significant boost to growth and they are a nice offset in the portfolio to larger, somewhat more mature companies.

We think that in terms of portfolio construction, our ability to match the large with the small and sort of synthetically create the middle gives us this opportunity to produce sustainable growth over time. We are very much driven by absolute returns.

Q: What is your biggest disappointment of a stock that you had?

A: We didn't have one this year, but I once owned Adelphia. It was a significant position for us and we were hurt. The offset was that as a portfolio we still produced good returns. So, I think we have done a pretty good job with risk management and the moment we saw problems at Adelphia, we just sold it.

Q: If a potential investor looks at your fund and considers putting some money into it, what can they expect and what they should not expect?

A: They should not expect us to always be in sync with the market. Because at the end of the day, we are a specialty fund and we do exclude significant sectors of the market. As a result, our task is to deliver good absolute returns over a long period of time, but our sector exclusions can cause us to be out of sync with the market periodically. We would accept that as just a part of our investment process. Investors should not lose sight of this fact. On the other hand, I think it is a fund that could be considered by an individual who is diversified across a number of funds or investment vehicles. Many traditional growth funds are managed with a bias away from financial services, and we view that as unnecessary. This fund is a growth fund managed with a bias towards the sectors traditionally excluded by the traditional growth fund. ▮

Alexander Vantchev

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