

Sustainable Growth in Focus

While most funds put in place tight screening criteria for the stocks they already consider buying, for some it all starts with a strict universe. The portfolio managers of the John Hancock U.S. Global Leaders Growth Fund look at a well-defined pool of large-cap companies with sustainable earnings growth potential and established global reach. This research-driven strategy allows the fund to maintain a strong buy discipline and low turnover.

Q: *What is the investment philosophy of the fund?*

George Fraise: Our core investment philosophy is to be long term investors in great businesses bought at a reasonable price. We are willing to be patient with our companies (on average, we hold stocks for more than five years) because they have one key element in common: sustainable above-average earnings growth.

Our experience has shown that over a long period of time certain characteristics increase significantly the probability that companies will be able to achieve and maintain sustainable above-average earnings growth. We look for three qualities in all the companies we invest in: first is pricing power; second is a high degree of repeat revenues; and third is global reach.

We first look for companies that control their pricing destiny. Not many companies can do this, but when they do, it puts them in a great position. They can set prices on their products and services at levels that consistently provide good profit margins and strong returns on invested capital.

A number of elements can lead to pricing power. Microsoft and Starbucks, for example, have a dominant position in

their industries. Johnson & Johnson and Gillette have proprietary positions with their products. Being a low-cost producer in an industry allows you to price at a discount to your competitors while remaining more profitable than the competition. Dell and Wall-Mart are perfect examples.

Our second key characteristic is a high degree of repeat revenues. We invest in companies whose products and services are used frequently and need to be replaced regularly. If you start every year with a core constituency of loyal customers already in the habit of patronizing your products and services, you're in a much better position to grow. Also, repeat revenues provide a higher degree of conviction that the growth will be predictable and sustainable.

Finally, we want global reach, the ability to expand a business model and take advantage of growth opportunities outside of the U.S. We like companies with no geographic or cultural limitations to their business model because the products and services they offer are used all over the world. If you think about sipping a latte in a Starbucks in Hong Kong while working on a Microsoft Excel spreadsheet on your Dell laptop, you get the idea.

Fund Facts

Symbol	USGLX
Website	www.jhfunds.com
Address	John Hancock Funds 101 Huntington Avenue Boston, MA 02199
Tel. No.	1-800-225-5291
Inception	9/29/95

Portfolio

Total Net Assets *	\$ 926.90
Avg Mkt Cap (\$ Weighted) *	\$ 93,534
Average Price/Earnings Ratio	26.34
Average Price/Book Ratio	9.05
Turnover Ratio	15%

Investment Information

New Investment	Open
Min Initial Investment	\$1,000
Min Subsequent Investment	\$25
Min Initial IRA Investment	\$500

Risk (Against S&P 500 - 3 Years)

Alpha	1.09
Beta	0.76
R-Squared	86.42
Ann Std Deviation	13.12
Sharpe Ratio	0.25

Returns vs. Lipper Large-Cap Growth Index

	USGLX	Index
1 Year (Cum.)	9.08	7.56
3 Year (Ann.)	4.64	0.61
5 Year (Ann.)	2.56	-7.30

Returns vs. S&P 500

	USGLX	Index
1 Year (Cum.)	9.08	13.86
3 Year (Ann.)	4.64	4.04
5 Year (Ann.)	2.56	-1.31

Fees and Expenses

Max Sales Charge - Front	5.00 %
Max Sales Charge - Deferred	5.00 %
Max Redemption Fee	0.00 %
Total Expense Ratio	1.36 %

Portfolio Manager

Adviser	John Hancock Advisers
Subadviser	Sustainable Growth Advisers, LP
Portfolio Managers	George Fraise, Gordon Marchand, Rob Rohn

* millions Data through: 09/30/04

Source: Company Documents; Lipper; Morningstar



TICKER'S Choice

Q: *What is your investment research process?*

Rob Rohn: Our entire research process is directed at finding companies with sustainable earnings growth. We conduct first-hand fundamental analysis and support our findings with the financial models that we build using data we collect through our research. We scrutinize the drivers of earnings growth and the factors that affect the quality of those earnings for each business we invest in.

First, we are selective with the companies in our universe, only allowing those few businesses that have the characteristics we described earlier to make it. Second, we are diligent in doing our research, and finally we are very disciplined about valuation.

A key step in our research process is to build financial models for companies in our universe. This action, building the income statement, balance sheet and cash flow statements for the business not only for the next year but for the next five to ten years, really helps us understand the financial dynamics of the business and its long-term prospects. It also helps us test the predictability and sustainability of the business over the long term. If we find ourselves at a loss trying to project the business out several years, then we know the business lacks the visibility we require.

The financial projections that we build in our research process help drive our valuation system. We use a number of valuation methodologies, some of which are proprietary. First we look at short-hand measures such as P/E ratios to growth rates and a Graham and Dodd formula. Second, we use a proprietary discount model which arrives at fair value by discounting the long-term earnings projections that are derived from our research work using the risk-free rate and an equity risk premium. Finally, we also take a hard look at cash flow and measure something we call Enterprise Yield. This is the measure of the true free cash flow available to shareholders as a percentage of market capitalization.

Q: *How do you describe your buy discipline?*

Gordon Marchand: The first step of the buy discipline is to make certain that the business has the three characteristics that make it a great business from our perspective: pricing power, repeat revenues and global reach. We then want to make sure that it has sufficient sustainable growth to qualify for our portfolio. Finally we want to ensure that we do not overpay for that earnings growth.

A company with great potential in the eyes of the investors and analysts, but no earnings yet, won't make it into our universe. Of course, future earnings and cash flow are important but current earnings and cash flows are important as well.

Ultimately, our investment universe encompasses between 30 and 40 compa-



nies. This works well for our firm because it allows each of us to focus on five to ten names. This enables us to know companies to a higher level of detail.

Our portfolio is constructed of 20 to 30 names, selected from our universe. Our portfolio position sizes are determined based on our view of the fundamentals and our view of the valuation. We will not let an individual position size rise above 8%, or an industry weighting within the portfolio exceed 25%.

Q: *There are three people in the investment team, how does your management team make investment decisions?*

Rob Rohn: There are actually five members of our investment team, including our two Research Principals. All members of the committee are seasoned analysts and participate fully in all investment

discussions. The firm's three founding principals, George, Gordon and myself, jointly make ultimate decisions in the portfolio. A discussion can be brought up to the committee by any of the members but the three of us must agree on every decision that takes place. Consensus is required for all buy and sell decisions.

We fundamentally feel that to be a portfolio manager you need to be an analyst as well. We also believe that a two-layer structure of analysis and investment decision-making within an investment firm can lead to imperfect communication. All of us are analysts with primary responsibilities for certain companies within our universe.

Q: *Can you give us some examples that highlight your buy/sell discipline?*

Rob Rohn: In the second quarter of 2004, we bought Genzyme, a leading biotechnology company that focuses on the treatment of rare, chronic genetic disorders. This focus provides the company with tremendous competitive advantages because its drugs are given what is called orphan drug status, meaning they are protected from competition.

Genzyme looked promising. We visited with senior management at their headquarters, meeting with the operating division heads in charge of each product group. We liked what we heard from them about their business model, but we also wanted a broader perspective of the industry so we met with their primary competitor, TKT.

We then met with Genzyme's CEO who answered our questions, giving us a sense for his motivation, leadership abilities and views on the outlook over the longer term. We also attended the annual meeting and had a one-on-one conference call with the CFO of the company.

We came away convinced and built a small position at the price of slightly above \$40. Our initial 2% position quickly appreciated when the stock went to about \$50. We did not want to chase the stock and typically look for opportunities to add to our positions when there is a short-term dislocation in the stock price. In retrospect, we wish that we could have

bought more in the beginning. At the same time, we want to get comfortable with companies and with management over time before we take a much higher position.

Q: *What is the portfolio turnover ratio?*

George Fraise: As we mentioned earlier, our core investment philosophy is to be long term investors in good businesses bought at a reasonable price. With an average holding period in excess of five years, we have a very low turnover. Since the fund's inception in 1995, it has been around 15%.

We make money for our clients by taking advantage of the growing earnings of the companies in our portfolio. All of our accounts are managed the same way. We decide to either go out of a position, or add a position to the portfolios by doing it across the board in all accounts that we manage.

Q: *Will you share with us an example of a company you have followed for a long time?*

Gordon Marchand: We owned Microsoft in the second half of the 1990s, but sold it in 1999. We were worried about antitrust issues, the litigation risk resulting from the many lawsuits the company was on the receiving end of and the emergence of a free competitor in Linux. The company was also experiencing a brain drain as some of its best people were lured away by the dotcom startups. In addition, our valuation work highlighted that the stock was priced for perfection.

Last year, however, we came back. The stock was now reasonably priced, having dropped more than 30% since our sale. Beyond that, the antitrust clouds were parting, the burst of the dotcom bubble reduced competition for employees and Microsoft appeared to have a coherent platform strategy going forward. Finally, we thought that the company would take some action to return its enormous cash flow to investors, something which started happening this summer.

In the short term, we're looking forward to the \$3 dividend the company will

be paying shareholders in December. Longer term, we're quite positive on the stock. The company is still generating over \$1 billion of free cash flow a month. Since we are focused on cash in our valuation system, it looks very attractive. Microsoft's cash earnings, which factor in the expense for issuance of options, have been growing at a good pace. We are looking at this sustainable double-digit growth

in the bottom line. In a world where the ultimate alternative is the 10-year bond that gets you the 4%, double-digit growth is terrific.

Q: *Perhaps you would like to provide us with an example of a stock pick that did not actually work for you?*

George Fraise: We sold Merck in January 2004 - well before the Vioxx revelations, as a matter of fact. In any event, Merck had been part of the portfolio since 1995, but we increasingly grew concerned about the research productivity at the company. They simply weren't coming up with new products and that was causing a slowdown in their growth. They had had a great run with a solid earnings growth for years and we expected the company to be able to increase research productivity, but it didn't happen.

In addition, we also began to believe that Merck's corporate culture prevented the company from external product development, unlike Pfizer, which has culture of working in joint efforts with other companies. A key rule in pharmaceutical business is that you have to continuously reinvent your pipeline. With no conviction that Merck would be able to deliver enough new products internally to offset the revenue decline resulting from the patent expiration on a number of its core products, we got out of the stock.

Q: *How do you manage investment risk?*

Rob Rohn: As a long-term investor the controlling risk is that something, be it a competitor, or a change in market dynamics, interrupts the expected progress of earnings and cash flow growth. Our process is designed to minimize that risk.

We lower business risk primarily by investing in high quality companies with predictable and sustainable earnings and cash flow growth. We then manage valuation risk by ensuring that we don't overpay for the solid earnings streams the companies generate. Finally, we follow certain portfolio construction guidelines to minimize concentration risk. ■

TICKER Staff

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about

The Team

The management trio of Fraise, Marchand, and Rohn have been together since 2003 when they became co-founders and principals of Sustainable Growth Advisers, LP, a New York based investment firm that sub-advises the fund for John Hancock Funds.

George Fraise has managed the fund since 2000. Previously, he was a portfolio manager at Scudder Kemper Investments, and a senior analyst at Smith Barney and Chancellor Capital Management.

Gordon Marchand was an officer, director and a member of the Investment Policy Committee of Yeager, Wood and Marshall, Inc. prior to 2003. Earlier in his career, he served as manager with the management consulting service group at Price Waterhouse.

Rob Rohn served as portfolio manager and analyst with W.P. Stewart & Co., Ltd. prior to 2003. Previously, he was a vice president at Yeager, Wood & Marshall, and an officer in Corporate Finance at Morgan Guarantee Trust Company.