

# Twenty Undervalued Growth Stocks

**K**nowing what you are looking for always helps in making investment decisions. Christopher Tsai, the manager of the Tsai US Large Cap Equity Growth portfolio of separate accounts, is not bothered by common misconceptions about the large-cap growth area or by the limited number of stocks in his portfolio. With a clear understanding of his clients' objectives, he has very specific requirements about what he buys and at what price.

**Q:** Would you describe your investment philosophy?

**A:** I don't place much emphasis on forecasting the direction of the stock market or the economy, because short-term market gyrations do not affect the long-term prospect of an investment. At the core of my thought process is the belief that a stock is not a piece of paper to be traded but rather represents partial ownership in a business. I believe that there is a strong correlation between the growth of a company's earnings and the appreciation of a company's stock price over the long haul. I therefore look for specific business fundamentals that I believe result in above-average profit growth. If we can find companies with better fundamentals than the average company, we can find companies that have the potential to outperform the market. Then it's a question of price. Discipline and patience are important elements of our investment strategy.

I mentioned that we look for companies with strong fundamental characteristics. By this I mean companies that have high rates of return on equity and

capital, strong free cash flow, above-average profit margins and dominant market share. We also focus on businesses that have rock solid franchises... those that have a competitive advantage and the flexibility to adjust to changing competitive conditions. Furthermore, we prefer companies that have predictable and sustainable growth prospects. You won't find traditionally cyclical companies in our managed portfolios.

**Q:** When managing money, are you looking primarily for growth, value, or preservation of capital?

**A:** Preservation and growth of capital are equally important. Our clients already tend to be wealthy and are not interested in winning the lottery. Rather, they want to grow their wealth over time at predictable and above-average rates, and they want to accomplish this with low volatility. That's Tsai Capital's focus.

One way we can reduce downside risk is by making an investment when we believe it represents value. I think we are disciplined. Valuation is very impor-

## Tsai US Large Cap Equity Growth

### Portfolio Facts

Type	Separate Account Composite
Category	Large Cap Growth
Website	<a href="http://www.tsaicapital.com">www.tsaicapital.com</a>
Address	Tsai Capital Corporation 405 Lexington Avenue, 26th Floor New York, NY 10174
Tel. No.	212-907-6401
Inception	1/1/1998

### Portfolio

Total Net Assets *	\$ 17
Avg Mkt Cap (\$ Weighted) *	\$ 61,000
Average Price/Earnings Ratio	20
Average Price/Book Ratio	6
Turnover Ratio **	25 %
AIMR Compliant	Yes
% Portfolio Tax Managed	100 %
% Portfolio Customized	10 %

### Investment Information

New Investment	Open
Min Initial Investment (Retail)	\$ 250,000
Min Initial Investment (Institution)	\$ 1,000,000

### Risk (Against S&P 500 - 6/30/2005)

Alpha	0.98
Beta	0.39
Composite Dispersion (YTD)	0.53
Yield	1.40 %

### Returns vs. Russell 1000 Growth Index

	TSAI CAPITAL	Index
1 Year (Cum.)	-2.50 %	1.68 %
5 Year (Ann.)	11.34 %	-10.35 %
Incep. (Ann.)	4.50 %	1.46 %

### Returns vs. S&P 500

	TSAI CAPITAL	Index
1 Year (Cum.)	-2.50 %	6.32 %
5 Year (Ann.)	11.34 %	-2.37 %
Incep. (Ann.)	4.50 %	4.33 %

### Fees and Expenses

\$0-\$5 Million	2.00 %
\$5-\$10 Million	1.75 %
More than \$10 Million	1.50 %

### Portfolio Manager

Christopher Tsai	Jan-1998
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\* millions \*\* Turnover is an estimate for 2005

Data through: 06/30/05

Source: Company Documents; Morningstar

Performance Figures are Gross of Mgmt. Fees.



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tant to us. And I am not just referring to P/E ratios. They can be misleading. Microsoft and Wal-Mart had very high P/Es when they went public, but they clearly represented value. We focus more so on the future cash flows of a business. If there is a company we would like to own but the price is just not right, we will put it on our radar screen and wait for an appropriate entry point.

But to answer your question, we are looking for growth, value and preservation of capital. I don't think there is a style box for that, but rating agencies place us in the large-cap growth category because our portfolio companies tend to have above-average growth rates and P/E ratios and our weighted average market capitalization is north of \$60 billion.

**Q:** *How important is your benchmark in terms of diversification and portfolio construction?*

**A:** The Russell 1000 Growth Index and the S&P 500 Index are the most appropriate benchmarks for our portfolios. I think benchmarks are important because they help one to judge results in all sorts of ways. But we don't create portfolios around benchmarks. We buy what we think makes sense. Our goal is to create a portfolio of no more than 20 of our best ideas...20 high quality and undervalued growth stocks. We also want to control the risk or volatility of the portfolios. Today, the Tsai US Large Cap Equity Growth composite of separately managed accounts is about 60% less volatile than the S&P 500 Index.

**Q:** *Historically, most people have relied on Wall Street's quarterly earnings estimates. How important are those numbers to you?*

**A:** First of all, we rely on internal research to make our purchase and sale decisions. What a company reports in relation to our internal forecasts is relevant. What a company reports in relation to Wall Street's estimate is relevant

to us only to the extent that it results in an opportunity in the marketplace. Secondly, we don't place as much emphasis on one particular quarter as on the results of a company's operations for a year. Management, for example, has a lot of latitude with respect to their depreciation estimate, which can get revised throughout the year.

**Q:** *What are the key factors in making your earnings estimate and in understanding the capacity, volatility or predictability of the earnings?*

**A:** I focus on companies and industries I believe I understand well. Tsai Capital is generally not involved in companies that have rapidly changing operations where it is difficult to predict the future. For example, there is not much technology in the portfolio because technology tends to change too quickly and that leads to unpredictability. We are looking for consistency and accuracy in our estimates.

It is also important to break down the business into its component parts. Looking at retail companies, for example, we want to understand how well each store is doing, the unit economics, returns per square foot, etc. In doing so, we believe that it is more instructive to speak with the competitors of a company than to the company itself.

**Q:** *How do you narrow down the potential investment candidates for the portfolio?*

**A:** The universe that I start with consists of about 2000 companies. After applying various screening criteria, that list is narrowed down to no more than 50 to 75 companies. For example, we look for strong historical revenue and earnings growth because they can help to demonstrate the consistency, or lack thereof, of a company's operations and the skill of a management team. We also seek out companies that can produce at least 10% earnings growth per year, above inflation, and businesses that have high return on equity and invested capital and little debt.

After the initial screening is completed, potential investment candidates get eliminated for other reasons. For example, housing stocks have performed very well over the past decade. Many have high return on equity and capital, strong top and bottom line growth rates and solid balance sheets. On the surface, these companies would appear to be investment candidates for the Tsai US Large Cap Equity Growth portfolio, but these are cyclical businesses and exactly the types of companies that we wouldn't want to own.

Additionally, we favor companies that have grown internally rather than through acquisition, companies that have small amounts of intangible assets and companies that do not have large amounts of one-time charges that often distort the true earning power of a business.

**Q:** *What sectors of the market do you find interesting today?*

**A:** One area that I consider very interesting is the healthcare industry. America is getting older. By 2030, 20% of the population will be over the age of 65, compared with just 13% today. Pharmaceutical companies appear to be logical beneficiaries of an ageing population, but looming patent expirations and FDA concerns make investing in pharmaceutical stocks more difficult than immediately apparent. One way to profit from the aging of the American population, I think, is to invest in a company like Walgreens, which is the largest retail drug store chain. If drug XYZ loses its patent or is pulled from the marketplace, consumers will purchase a competing drug to treat the illness. Walgreens makes the sale anyway. This will be a growth story for a long time.

**Q:** *Would you consider the possibility that the best years of Walgreen's growth may be already in the past?*

**A:** Yes. Something like that must be considered with any growth stock. An investor must also consider what the fu-

ture growth might look like for the business as well as for the stock. As I mentioned earlier, over long periods of time there is a high correlation between the growth of the business and the growth of the underlying stock price. But over shorter periods of time, there can be a disconnect. For example, Walgreens did very well in 90s and into the early part of this decade. But the stock eventually got ahead of the business. After peaking around the early part of 2001, Walgreens' stock began to decline. This happened even though the earnings of the company were increasing. It took a couple of years for the earnings to increase to a level that justified the stock price, and then the stock began to move higher again. These periods are actually very typical of growth stocks, which tend to move in a step-like pattern.

**Q:** *Since a number of recent frauds have happened in the large-cap area, what precautions can one take?*

**A:** It is certainly not a science, but there are a number of things that an investor can look for. And this applies to small, mid and large-cap companies. For example, we like it when management owns a meaningful amount of stock, and I am not talking about stock options. We like to see direct ownership so the interest of management is more aligned with that of the shareholder. We also think that there is less chance of fraud when a company grows internally as opposed to through acquisition. Most all of our portfolio companies have grown primarily organically. In the heat of marriage a lot of things can be swept under or charges can be taken up-front when they should have been accrued over time.

**Q:** *Would you describe your portfolio construction process in terms of the buy and sell discipline?*

**A:** We have a 5-step process, which includes screening, identification, research and analysis, valuation, and allocation. But ultimately our buy disci-

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about **Christopher Tsai**

**Christopher Tsai**, founder of the company, has been a director and the President and Chief Investment Officer of the company since November 1997. Prior to joining the company, Mr. Tsai held an analyst position in the Equity Research department at Bear, Stearns & Co. Inc., a leading global investment banking, securities trading and brokerage firm. Before that, Mr. Tsai managed money mostly for High Net Worth individuals with Tsai Asset Management, Inc., a private investment management firm that he founded. Earlier, he was an apprentice at Tsai Management, Inc., an investment firm founded by Gerald Tsai, Jr.

Mr. Tsai received his B.A. degree in philosophy and international politics from Middlebury College, where he was selected to serve as a Young Alumni Advisor.

pline is rather straightforward; we purchase growth companies at a discount to what we think they are worth.

We will sell a stock for two reasons. First, if we think the fundamentals will deteriorate. This is forward-looking because the market is very quick to adjust to changes in fundamentals. We have to anticipate them. Having a focused portfolio of 20 companies gives us the ability to continuously monitor changes in the fundamentals of the investments. We will also sell a stock if the sale and subsequent reinvestment of the sale proceeds will result in substantially greater future value. In that case, the risk related to a new investment might be equal or less than the initial investment.

**Q:** *You run a relatively concentrated portfolio and any success or failure in one stock could have a pronounced effect on your performance. Are your investors concerned about that?*

**A:** No. With 20 stocks in our portfolio, the average position is 5%. I don't think that is very large, particularly when one considers the quality of the companies that are in the portfolio. There are only six companies, for example, that hold an AAA rating by Standard & Poor's. We own two of them. We would rather own a portfolio of 20 high quality companies that are purchased at reasonable valuations than a portfolio of 200 mediocre companies. Our portfolio is comprised of 20 leaders in their respective industries and that lowers the risk profile significantly. Our philosophy is to focus on the best.

I would also like to add that since we run a large-cap growth portfolio, many people assume that we are more volatile than the market. But as a result of our investment philosophy of choosing companies that have predictable and sustainable growth prospects, we have created a portfolio with a beta of about 0.40, or one that is 60% less volatile than the S&P 500 index. ■

**TICKER Staff**