Wrong Calls Make Right Buys

Growth only matters when it counts in the stock market. For Charles McCurdy and his team, the meaning of growth is the ability of a company to show consistency in beating the earnings estimates on the Street. Thus, the ABN AMRO/Veredus Select Growth Fund is looking for growth stocks beyond traditional growth definitions and growth sectors.

Q: ***How is your fund different from the hundreds of other growth funds?***

A: We approach growth in a different way than most other growth fund managers. Traditional growth approaches tend to look at projected 3-to-5 year earnings and revenue growth rates. We know that annual and quarterly earnings estimates tend to be wrong – they are either too high or too low – and the difference between actual earnings and estimated earnings in the near term can be quite large. Earnings surprises tend to persist, sometimes for extended periods of time. Certainly, if there are errors in estimating near term earnings, longer term estimates tend to have even greater margins of error. This poses great potential risk to traditional growth investing if there is significant error in long term growth forecasts. Street analysts continually make revisions to their estimates to reduce their margin of error; but, generally speaking, those revisions tend to be small, reflecting only the most recent earnings news, and it can take several quarters, even years, for Street expectations to even come close to the earnings that a given company might actually report. So, our starting point is to screen for companies that have a history of positive earnings surprise, as well as a history of positive revision in analyst earnings estimates. Our goal in analyzing companies that pass our screens is to ascertain just how wrong consensus estimates might be, and then assess how long it may take Street analysts to reduce their forecast error to a minimum. The longer it takes for the Street to get their forecasts right, the more opportunity it creates. This element of persistence to earnings surprise is what gives us an edge.

Q: ***For example, Microsoft has been beating estimates for the last five years. How would you handle Microsoft?***

A: On balance over the last five years, reported earnings for Microsoft were essentially in line to slightly better than expectations, with a few quarters where the company beat estimates by more than 10%. However, Microsoft also reported disappointing earnings for a few quarters over that

ABN AMRO/Veredus Select Growth

Fund Facts

Symbol	AVSGX
Website	www.abnamrofunds.com
Address	ABN AMRO Funds PO Box 9765 Providence, RI
Tel. No.	800-992-8151
Inception	01/01/2002

Portfolio

Total Net Assets *	$ 4.5
Avg Mkt Cap ($ Weighted) *	$ 16,500
Average Price/Earnings Ratio	19.4
Average Price/Book Ratio	6.2
Turnover Ratio	250 %

Investment Information

New Investment	Open
Min Initial Investment	$ 2,500
Min Subsequent Investment	$ 50
Min Initial IRA Investment	$ 500

Risk (Against S&P 500 - 3 Years) 3/31/05

Alpha	3.3
Beta	0.92
R-Squared	0.89
Ann Std Deviation	18.85
Sharpe Ratio	0.24

Returns vs. Lipper Large-Cap Value Index

	AVSGX	Index
1 Year (Cum.)	17.60 %	10.03 %
3 Year (Ann.)	9.19 %	5.44 %
5 Year (Ann.)	NA	1.50 %

Returns vs. S&P 500

	AVSGX	Index
1 Year (Cum.)	17.60 %	8.24 %
3 Year (Ann.)	9.19 %	5.60 %
5 Year (Ann.)	NA	-1.93 %

Fees and Expenses

Max Sales Charge - Front	0.00 %
Max Sales Charge - Deferred	0.00 %
Max Redemption Fee	0.00 %
Total Expense Ratio	1.30 %

Portfolio Manager

Team Managed	

** millions*

Data through: 05/31/05

Source: Company Documents; Lipper

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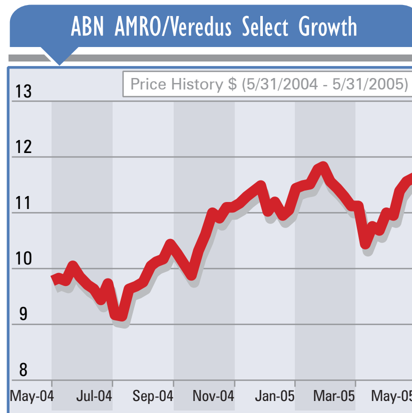
time frame, the company reduced earnings guidance on several occasions, and Street analysts responded to disappointment by revising estimates down. From our perspective, disappointing quarterly earnings and reduced expectations are enough of a negative to keep us out of the stock, or force a sale if it was already in a portfolio. From a traditional growth approach, in June 2000, the long term growth expectations were for 22% growth. But, by June 2005, the company only delivered half of that expected growth rate. Such a reduction of expectations in the life cycle of what is perceived to be a growth company can be a death knell for investment performance – indeed, the stock is down 30% from June 2000 to June 2005, where the S&P 500 is down less than 20%. The stock underperformed while expectations were being compressed.

When one thinks of classic growth stocks, Microsoft comes to mind immediately. Cisco, Dell, and Starbucks are other high-profile examples – they are indeed all "growth"companies from the point of view that growth expectations have always been fairly high, but from an investment perspective, they weren't always meeting and exceeding expectations. We do not think that anyone is smart enough to predict long term growth rates, yet that element is the starting point for many growth investors. These companies have great growth records, but they were built one quarter at a time. We want to stick with names that are actually delivering on the growth. One of the traps in growth investing when investors are disappointed in a given quarter is to rationalize the shortfall and respond with, "Well…it is still a 25% growth company." Given a recent disappointment, longer term expectations immediately become highly suspect. This is exactly why growth stocks fall from grace in spectacular fashion when there is a hiccup in a growth trend. But when a company is meeting or exceeding expectations from quarter to quarter, they are certainly on track to meet that long term growth expectation, regardless of how high or low the expected level of growth may be.

Q: ***So, you are more focused on quarterly, or annual expectations?***

A: Our primary screens are driven by changes in annual earnings estimates, but we look at both quarterly and annual earnings estimates. An initial quarterly earnings surprise will draw our attention to a name, and that



will trigger upward revision in annual estimates. But, generally speaking, we want to see at least two positive quarters before we invest in a company. There are many companies that are not able to sustain a string of positive earnings surprises; so, looking for two quarters of earnings surprise keeps us away from a lot of false starts on the earnings front.

Q: ***So, you are basically looking for consistency in surprises and disappointments? And you are kind of trying to arbitrage the volatility?***

A: We are looking for companies that can beat expectations on a sustained basis. Volatility is certainly a secondary consideration. Universally, the homebuilding group is not viewed as a growth industry, yet these companies have streaks of positive earnings surprises in excess of 25 to 30 quarters. Why is it that the street has not been able to predict earnings accurately? For more than six years, the industry has beaten street estimates – SIX YEARS!! Quarter in and quarter out, for over six years, the homebuilders have been beating estimates by 10% to 15%. The companies then raise earnings guidance, the street raises their estimates, and the process repeats itself. Looking back, the group has now compounded earnings in excess of 30%, but the expected growth rate has never been higher than 10%. As a result, the stocks are up more than tenfold in the last five years. The homebuilders are a quintessential example of our process in action, but they also represent the polar opposite of a "classic growth" stock like Microsoft in that expectations can indeed be too low for a long period of time.

Q: ***How do you go about doing your research?***

A: Once a company passes our screens, our analysts conduct fundamental research. When a company delivers an earnings surprise, we are trying to determine what is driving financial performance – whether it is volume, pricing, product mix, margins... or financial engineering. We pay close attention to Street earnings models so that we know which factors might surprise the Street and give rise to successive earnings surprises. We develop our own in-house models which, more often than not, generate earnings estimates that are materially different than consensus. Those companies that show the largest positive differential versus Street estimates, but also where we have conviction that the companies can actually deliv-

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er on our higher expectations, are the ones we invest in. We also apply technical analysis in our process, but we use technicals as a confirmation of what we find fundamentally. We want to see that when the market is surprised by better than expected news, market mechanics reflect that in the form of higher trading volume, positive money flows, and superior relative strength. Technicals also allow us to identify entry and exit points, because we wish to be opportunistic from a trading standpoint when we have a high level of fundamental conviction. We want to be overweighted in names where we have a combination of a near term earnings catalyst and a prime entry point, and being aware of the technical condition enables us to do that.

Q: ***How would you define your investment process then? Do you track sectors at all?***

A: We screen on a bottoms-up basis, and the portfolio is constructed the same way. We're stock pickers, and we're not looking to make sector bets on a top-down basis. However, through our process of stock picking, the portfolio can become concentrated in various sectors from time to time.

Q: ***How do you avoid that?***

A: Concentration is not necessarily a bad thing. When we have conviction in a sector, we make the portfolio weighting significant. From a risk control standpoint, our typical constraint limits a sector weighting to no more than twice the sector weighting in the S&P. That said, we do not benchmark versus any index. If a group of stocks is totally absent from our screening, there is no reason to have representation on the portfolio, so we would have zero exposure in that group. If we are finding groups of stocks that have the same earnings characteristics, and if we feel those will be sustainable, we'll overweight those areas in the portfolio. Typically, we're going to have between 40 and 50 stocks in the fund.

> "The key to success for our approach is being more accurate than Wall Street on the true earnings power for any given company, and then having Street expectations move toward our estimates over time. The closer they get, the less opportunity there is."

about Charles P. McCurdy, Jr.

Charles (Chuck) P. McCurdy, Jr. is a co-founder and principal member of Veredus Asset Management LLC; he serves as EVP of Veredus and Portfolio Manager. Prior to founding Veredus, Mr. McCurdy was Vice President and Director of Research for SMC Capital in Louisville, KY from 1994 to 1998. From 1992 to 1994, he was Vice President and Manager of Trust Investments at Stock Yards Bank and Trust, and from 1986 to 1992, he was a Research Analyst and Portfolio Manager for Citizens Fidelity Capital Management, both in Louisville, KY. Mr. McCurdy holds a B.S. in Finance from the University of Louisville; he is a Chartered Financial Analyst.

Q: ***The turnover is going to be higher, then?***

A: Yes, it would be higher. Historically, the portfolio turnover has been between 200% and 250%. This is in line with, but slightly higher than our small-cap strategy, which is really the core of what we do. The process is identical across market capitalizations, so the portfolio metrics, turnover, sector weightings are going to look fairly similar. We are confident that we can achieve success across all market caps – the ABN AMRO/Veredus Select Growth Fund is our vehicle for delivering performance in the mid-cap and large cap arenas.

Q: ***So, the majority of the holdings are in the small-cap?***

A: For our core small cap strategy, that is true. However, for the ABN AMRO/Veredus Select Growth Fund, we're looking at companies with market caps of $3 billion and higher. It is more of a mid- to large-cap product.

Q: ***Did you follow the same strategy in 1999-2000?***

A: Our investment philosophy and process has been unchanged since we founded Veredus in June 1998. We have applied it successfully in the small cap segment since inception. The ABN AMRO/Veredus Select Growth Fund was started at the end of 2001, and to date, we have been able to deliver good performance with the identical philosophy and process that we have used in small cap since 1998. ∎

TICKER Staff

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