Focus on Fundamentals

In the growth space, making the right long-term bets is only attainable through the support of systematic research. Rudolph Carryl, the portfolio manager of the MainStay Mid Cap Growth Fund, has utilized fundamental analysis to deliver above-average returns at relatively low risk levels.

Q: *How do you define the investment philosophy of the fund?*

A: There are three key elements to our investment philosophy. First, it is based on a disciplined stock selection process, which emanates out of solid fundamental analysis. Second, we pride ourselves in employing a bottom-up approach in our stock selection to make sure that each stock is included in the porftolio based on its own individual merits. There is no market timing involved in the portfolio construction process as well as we do not make any sector rotation bets. The third component to our philosophy is the strict risk control. Regardless of the market conditions, we are particularly mindful that we do not take a lot of stock-specific risk.

Q: *By using this philosophy, how do you put together your mid-cap growth portfolio?*

A: The investment process starts with a standard approach of screening a universe of around 7,000 stocks. For this product the so-called opportunity set is focused within a market cap range of $500 million to $10 billion. In addition, we are looking for stocks with sufficient trading liquidity in case we want to get out of the stock. Obviously, the mid-cap space is not as liquid as that of large-cap companies, so we try to ensure that these characteristics exist before we invest in a stock. That pretty much leaves us with a secondary universe of about 1,000 stocks, which are then ranked according to five criteria.

By using historical data for the 3-year EPS growth rate, we are looking for companies that are growing their earnings at an above-average rate. Also, it is of primary importance for us to determine the positive earnings acceleration of a company. At number three on our list of criteria, we want to make sure that the top line is the key driver of the bottom line or, in other words, that revenue generation is the real driver of a company's earnings growth. In recent years we have seen many companies report very strong EPS numbers, but in many cases those numbers were aided by non-recurring factors such as, for example, artificially low income tax rates. These three characteristics of a stock represent our fundamental factors, while the fourth factor stands for what we are going to pay for the above-mentioned fundamentals. At this stage we look at the P/E growth rate on a 3-year trailing basis. Finally, we pay attention to a relative strength measure. Since good companies do not necessarily translate into good stocks, we want to

MainStay Mid Cap Growth

Fund Facts

Symbol	MMCPX
Website	www.mainstayfunds.com
Address	MainStay Funds 169 Lackawanna Avenue Parsippany, NJ 07054
Tel. No.	800-624-6782
Inception	01/02/01

Portfolio

Total Net Assets *	$ 108.70
Avg Mkt Cap ($ Weighted) *	$ 3,583
Average Price/Earnings Ratio	22.51
Average Price/Book Ratio	4.26
Turnover Ratio	52%

Investment Information

New Investment	Open
Min Initial Investment	$ 1,000
Min Subsequent Investment	$ 50
Min Initial IRA Investment	$ 1,000

Risk (Against S&P 500 - 3 Years)

Alpha	4.51
Beta	0.92
R-Squared	0.5507
Ann Std Deviation	18.23
Sharpe Ratio	0.50

Returns vs. Lipper Mid-Cap Growth Index

	MMCPX	Index
1 Year (Cum.)	20.29 %	7.43 %
3 Year (Ann.)	9.40 %	5.62 %
5 Year (Ann.)	N/A	-4.74 %

Returns vs. S&P 500

	MMCPX	Index
1 Year (Cum.)	20.29 %	8.23 %
3 Year (Ann.)	9.40 %	5.59 %
5 Year (Ann.)	N/A	-1.92 %

Fees and Expenses

Max Sales Charge - Front	5.50 %
Max Sales Charge - Deferred	0.00 %
Max Redemption Fee	0.00 %
Total Expense Ratio	1.50 %

Portfolio Manager

Rudolph Carryl	01/2001
Edmund Spelman	01/2001

* *millions*

Data through: 05/31/05

Source: Company Documents; Lipper

Q&A

TICKER's Choice

be certain that those good fundamentals and the attractive valuation characteristics are being recognized in the marketplace. Once we have ranked the stocks based on the five measures, the highest ranked stocks are then subject to research and fundamental analysis.

Q: ***Could you elaborate on your research process?***

A: At Mackay Shields, we bring a lot of value to the table in the field of fundamental research. The major reason for this practice is that every person working on this product is first and foremost a fundamental research analyst. Although we have come with different backgrounds, it is fundamental research that we pride ourselves in doing. That involves going back to the original financial statements to confirm that the numbers of a stock are truly reflective of the company's underlying earning power and business model.

In addition to income statement analysis, in recent years we have included significant cash flow and balance sheet analysis as a supplement to our research analysis. We are looking for companies that are very good free cash flow generators with enough staying power to endure a change in the economic and business conditions. Before we can determine if a company has the ability to overcome such difficulties, we look at its long-term debt to total capital to make sure that there is not a tremendous amount of leverage on the company's balance sheet. We recognize the fact that the market cares about what is going to happen in the future and it is going to pay for this high level of earnings visibility. That is why we try to detect a catalyst that takes the company to the next level. We can see such catalysts in innovative products, geographical expansion or accretive acquisitions.

Q: ***Can you provide us with some examples of stocks and industries where you have found such catalysts?***

A: A good example of a catalyst with an emphasis on geographical expansion would be Coach, which since 2001 has more than tripled its sales in Japan despite the competition from some of the biggest names in the industry. We are viewing Coach as a company with substantial earnings growth, driven by solid revenue generation. The company also keeps reinventing itself through a topical broadening of the product base in addition to the geographical diversification.

We also pay attention to management changes as company events viewed positively not only by the Street but by shareholders too. We have owned for a long time Quest Diagnostics, which is the nation's leading test diagnostic company with a market capitalization of just about $10 billion. The company's new CEO Surya Mohapatra has done a great job in taking the company into a direction of more esoteric testing that carries higher profit margins. Additionally, he has been working with managed care companies with a laser-beam focus to lower overall healthcare costs. The brilliant stroke under his program to control costs is the coordination with managed care companies, which guarantees that patients are tested before they may have to be hospitalized due to a serious problem.

As for industries, a change in the competitive landscape may generate a catalyst for a particular company if it has the opportunity to create more dominance in its market niche. For example, in the top 20 U.S. homebuilders represented about 8% of the homebuilding space 10-12 years ago, whereas now these companies stand for 20% of a market, which totals over $250 billion in size. We like the fact that the top players in this market benefit from their dominance to widen their capital and competitive advantages over smaller builders.

Q: ***Would you describe the process of buying and allocation in the portfolio?***

A: Typically, we initiate our entry point with a stock purchase at about 75 basis points that we may gradually raise to around 2.5%. While trying to identify the most propitious time for the stock purchase, we would consider three technical factors. We are looking for confirmation of the relative price strength. If the stock we are looking at is behaving in a weak manner relative to the other stocks in the group, that will give us a cause for a pause. Then, we check the status of money flows in which we want to see more accumulation as opposed to distribution in that particular stock. The third factor for consideration is the level of activity of insider transactions. Naturally, we take the position that insiders are more knowledgeable about a company than anyone else, so should they start aggressively disgorging the stock, we would have to reconsider our holding.

In the final stage of the buying process we construct the portfolio with an emphasis on the minimization of risk. As we put together the portfolio we want to make sure that no single stock or sector is going to dominate the portfolio. That said, we will never allow a stock to exceed 5% of the portfolio value. Despite the 5% limitation to stock holdings, in reality a single stock rarely goes beyond the 2.5% threshold. As of the end of February 2005 the top 10 holdings represented roughly 20% of the portfolio. As far as industry exposure is concerned, no sector is going to be allowed to stand for more than 25% of the portfolio, or 1.5 times the benchmark, whichever is greater. We have found over time that the most suitable benchmark for the portfolio is the Russell Mid-Cap Growth Index.

Q: ***How strict is your sell discipline?***

A: Our sell disciplined is built around four factors that may motivate a decision to sell a portfolio holding. Above all, we will consider selling a stock if we notice a change in the fundamentals of the company. For instance, we will see a dramatic slowdown in earnings or a product delay as a reason to place a stock on the watchlist. Recently we sold a stock called New York Community Bancorp due to a harsh deceleration in earnings, forced by ill-timed bets on interest rates. The second reason to sell a stock is weak relative price action, which we observed in JetBlue and Skywest when higher oil prices began to affect stock prices of regional airline companies.

The next reason to execute our sell discipline is a situation in which the valuation of a stock appears out of line, causing the stock to be traded at a much higher price relative to its underlying fundamentals. An appropriate example corresponding to this factor would be Claire's Stores. Lastly, we will be forced to trim back a stock if it reaches the allocation limit of 5%.

Q: ***Would you tell us about a stock pick that worked well for your portfolio?***

A: We have held D. R. Horton, the nation's leading homebuilder, for almost the entire life of the fund, and the stock has been a tremendous performer since its entry into the portfolio. What we particularly liked about D. R. Horton was the way the company, as a major player among smaller companies in its industry, was exerting its competitive advantage over minor builders. For example, D. R. Horton did not experience problems with the supplies of cement at a time of a shortage caused by China's huge demand for raw materials. As a result of its size and influence on suppliers of raw materials, the company succeeded in meeting its home deliveries of cement, unlike many of its lesser competitors. Additionally, homebuilders are benefiting from a positive demand-supply situation on the back of favorable demographic indicators, including ageing Baby Boomers, as a considerable buying force in the vacation home market, and today's immigration that comprises people with good educational background and earning power.

Even though rising interest rates may be seen as a concern for companies like D. R. Horton down the road, the offseting factors to higher interest rates, historically, have been increased consumer confidence and higher employment levels. Moreover, homebuilders have done a very good job in cleaning up their balance sheets, so increasing interest rates are not going to affect these companies as much as they did in the 80s. A look at the balance sheets of homebuilders from 10 years ago would show that debt to total capital was in the 60%-70% range, whereas now it is only around 40%.

> "We are looking for companies that are very good free cash flow generators with enough staying power to endure a change in the economic and business conditions."

about Rudolph Carryl

Mr. Carryl has managed MainStay Capital Appreciation and Total Return Funds since 1992, and MainStay Small Cap Growth and Mid Cap Growth Funds since their respective inceptions. He has also managed the MainStay All Cap Growth Fund since August 1992. Mr. Carryl is a Senior Managing Director of MacKay Shields. He joined MacKay Shields as a Director in 1992 and has 24 years of investment management and research experience. Mr. Carryl was Research Director and Senior Portfolio Manager at Value Line, Inc. from 1978 to 1992.

Q: ***Would you also give an example of an investment that has not been so successful?***

A: When we bought Health Management Associates, a Florida-based hospital management company, the stock's fundamentals could not have been more positive. The company was benefiting tremendously from the demographic trend of an ageing population. However, there was a change throughout the industry, which caught a lot of people by surprise. We found out that level of unpaid bills coming from the indigent increased dramatically, prompting many analysts, myself included, to lower the revenue and earnings projections for HMA and similar companies as well. Eventually, we saw the numbers come down dramatically both at the top and bottom line, so we had every reason to sell the stock. Since then the industry has improved the collection of bills but we did not gain from HMA at the time, because the deterioration of the fundamentals constrained us to sell the stock.

Q: ***What risk controls have you put in practice?***

A: The risk return profile of the fund has been extremely positive since its inception, offering above-average returns for relatively lower risk. The composition of the fund shows that the PEG ratio is 0.74% compared to 1.14% for the Russell Mid-Cap Growth Index and an even higher PEG ratio for the Russell 2500 Index. As I mentioned earlier, we reduce stock-specific and industry risk by strictly controling the size of portfolio holdings as well as our exposure to industries. Since we use our analytical approach to stress on strong fundamentals, by ignoring day do day fluctuations of stocks, the fund offers relatively low turnover ratio of around 50% as compared to most growth managers. For us, the key to successful investing lies in holding on to stocks through turbulent times while keeping an eye on fundamentals that are the true indicators of problems and quality. ■

TICKER Staff