

Sustainable Returns Through Leaders

To appear on the radar of the Thompson Plumb Growth Fund, a company has to display consistent growth, solid fundamentals, and attractive valuation. Above all, it has to be well established in an industry with sustainable – not cyclical – trends, and high barriers to entry. Despite the underperformance of his style in recent years, the manager John C. Thompson sticks to the quality large-cap growth stocks in expectation of an inflection point

Q: What are the core beliefs behind your way of money management?

A: Our philosophy is that the companies that generate high returns on shareholders equity tend to have strong positions within their industries. They usually operate either in oligopolies, or in industries that aren't very competitive. So the companies we invest in should rank high in their industry after analyzing the competition, the barriers to entry, the supplier and buyer bargaining power.

We believe that we can achieve superior returns by identifying high-quality growth companies for which the market has extrapolated a near-term issue, like an earnings slowdown, as a long term change in the company's growth outlook.

Once we find a group of companies that meets those criteria, we look for the ones that trade cheaply relative both to our estimate of their worth and to their historic levels. Generally, we buy stocks when their price-to-earnings ratio is one or two standard deviations below the average. With that approach we aim to participate both in the growth of the company and in the reversion to or above the mean of the P/E multiple.

Q: What's your definition of a quality growth company?

A: We look for growth, but not for cyclical

growth. We target companies that grow and provide high returns on equity regardless of the economic conditions. Examples of such companies include Johnson and Johnson, Coca-Cola, and Proctor and Gamble. The growth rate is less important to us because we understand that the multiple is a function of the growth rate. We simply pay a lower multiple for slower growth and a higher multiple for faster growth.

But the most important part is having realistic assumptions about the growth and its rate. We spend a lot of time analyzing the fundamental prospects of individual companies and whether their markets are big enough to facilitate further growth.

Q: How do you translate this philosophy into an investment strategy and process?

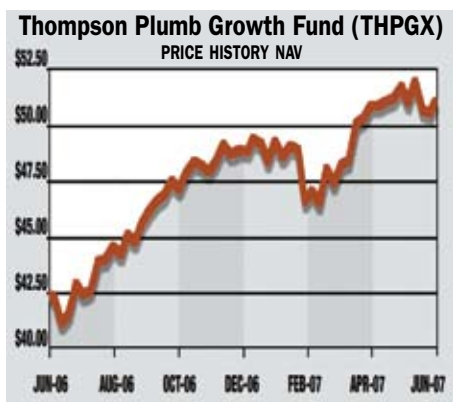
A: The strategy uses a "reversion to the mean" approach, which is based on the idea that if a company is trading at one standard deviation below its historic average, everything else equal, there is an 84% probability of multiple expansion. If you can buy that company at two standard deviations below the mean, the probability for expansion increases to 98%.

For example, if we consider a large-cap company with a long track record of P/E multiples, we'll go back 20 years to find its



JOHN C. THOMPSON CFA has been Vice President of Thompson Investment Management since its inception in January 2004. Prior to that, he was a Research Analyst and Portfolio Manager for Thompson, Plumb & Associates since 1993. Thompson holds a Bachelor of Science degree from the University of Wisconsin-Madison and a M.B.A. from the University of Chicago, and he also holds a Chartered Financial Analyst designation.

“If a company is trading at one standard deviation below its historic average, by definition, there is an 84% probability of multiple expansion. It is the combination of that expansion and the growth of the company that drives our performance.”



average multiple, the high, the low, and the standard deviation. We look at periods of higher interest rates, inflation, recessions and strong economic times to adjust our expectations for the environment we foresee. It is the combination of reversion to the mean and the growth of the company that drives our performance over the long term.

In our valuation screen we use different metrics for the different industries. These metrics may be price-to-sales, price-to-book, or price-to-earnings, depending on what's more appropriate for the specific industry.

Q: What has been your strategy in the past five or six years, when high-quality names, such as Coca-Cola, Microsoft, or Cisco have been growing, but their stock failed to provide any substantial return?

A: You are right, those stocks have not done well in the past five or six years; in many cases, they have had negative total returns since 2000. I believe that one of the reasons is that the hangover from the late 1990s continues. In other words, individual and professional investors still remember the losses in large-cap growth stocks and are very cautious about stepping back into that portion of the market. Clearly, these stocks were trading at inflated multiples but investors seem to have eliminated them from consideration despite the attractive valuations and earnings growth that we are witnessing today.

These stocks are at their cheapest levels in twenty years relative to themselves, the market, interest rates, and expected growth. The

fundamentals of these companies are also strong - Microsoft and Coca-Cola recently both reported quarterly revenue growth of 17%. The earnings of these companies are growing rapidly but the market is undervaluing them because of the perception of more exciting opportunities in China's demand for steel, copper, machinery, etc, which are areas with superior recent returns. Ironically, China will become a net exporter, or competitor, to many of these cyclical companies which will likely drive profit margins, and stock prices, much lower in the future.

Many of the biggest companies are trading at multiples that are far below their long term averages. For example, General Electric trades at 16 times forward earnings, Microsoft trades at 18 times, and Coca-Cola at 18 times compared to twenty year average multiples of 20, 37 and 30, respectively.

Investors appear to be confusing the compression of the multiples with the quality and growth of the companies. If the stocks aren't moving, they want to reallocate elsewhere and have been in droves. Because of the money flow that causes multiple compression, it has been difficult to make money in these stocks. Interestingly, money flow is a contra-indicator of future performance. For example, huge sums were invested into large-cap growth and out of small and mid cap stocks in the late 1990's, with disastrous results. We expect this historical pattern to repeat once again.

Q: What are your expectations for those companies, even though they are trading at a discount? How long can you wait for the multiple expansion?

A: Our investment horizon is quite long. For example, we have owned Microsoft for six or seven years. The stock has delivered a return of 40% or 50%, including the special dividend, but it clearly hasn't performed as well as the overall market.

However, selling because of underperformance of large caps would mean allowing the stock prices to change our strategy. The stocks that are performing well lately vio-

late many of our fundamental and valuation criteria: many are cyclical, have low barriers to entry, inconsistent returns on equity and often experience major earnings declines. Again, the fundamentals of Microsoft's are excellent and there is a good chance that Microsoft drastically outperforms the currently better performing stock that we replaced it with.

Overall, we believe that as long as the fundamentals of that company meet our criteria, the market will eventually realize it. Giving up too early is devastating for long-term performance. In the late 1990s, we were in a similar position as we sold many of our technology stocks at incredibly high valuations, and bought old economy stocks such as financials, mid-caps, and retailers. Sticking to our knitting in that period was quite painful but the market eventually caught up and the strategy worked extremely well in the next five years.

So we cannot predict the timing of the inflection point, but when the market valuations don't make sense, we are very confident that the inflection will occur. We have learned over the past couple of decades that market participants often follow emotions and overpay for currently rapid earnings growth. Inevitably, the environment changes, and when the change occurs, it is usually rapid and back into our favor.

For example, a lot of U.S. money right now is invested in the direction of the booming Chinese and Indian markets. Those economies are clearly doing well and that's the major reason for the investments. Investments are made not because the companies are cheap, well positioned and undervalued, but because the market is booming and they feel that they must participate. As the market inevitably has cyclical downturns, the same investors pull the money out just as quickly, like in the Asian Tigers crisis in 1990s. They can't stand the losses because they become cautious about their retirement.

Q: How do you generate ideas?

A: Similarly to most investors, we watch the markets, follow the newspapers and the data services, and attend research conferences. But reading and watching the markets is our primary source of ideas. We also check the 52-week low screens not because we are looking for deep value, but because we would investigate further the high-quality stories that trade at a 52-week low. We like looking at fallen angels although, just because a stock goes down, it doesn't mean it's going to go back up. But it definitely can.

Q: Would you highlight your research process?

A: We look for companies that generate consistently high returns on equity in good and bad times, and for companies with solid credit ratings and balance sheets. That approach tends to exclude most of the utilities, metal companies and mining companies. We don't invest in the airlines, for example, because of the high capital intensity, the competitiveness, and the power of the unions.

Many highly-cyclical companies, like various coal and steel producers, were bankrupt 10 years ago. They are doing extremely well now because of the high price of commodities. We are not forecasters of commodity prices, however, we strongly believe in microeconomics. So we are confident that in a commodity industry, price will trend toward marginal cost. Unfortunately, for most commodities, the marginal cost is much lower than the current prices. We would rather stay out of these industries as, by definition, economic profit over a cycle should be close to zero.

So our first requirement for a company is being in the right industry. The valuation screens and the fundamental due diligence come second. Above all, we have to be convinced that the industry has sustainable trends and improving fundamentals. Then we identify the most attractive companies in that industry to research. In other words, we are looking for the leaders.

The next step in our research process is examining the quality and the consistency of the earnings. We look at the margins, if they are stable, growing, or over-earning. If the margins are depressed, is there a catalyst to accelerate them? Is the revenue growth steady? Are the earnings at least stable or, preferably, growing and about to accelerate?

We review the company financials thoroughly and once the companies pass the fundamental test, we move on to valuation. We look for companies trading significantly below their long-term average or where we think they're worth. eBay traded at 5,000 times earnings in 1999; clearly we don't expect that it will ever go back to that type of multiple.

Q: Do you consider their competitive advantages in global perspective?

A: Yes, and Coca-Cola is a great example of that. It hasn't done well lately in the U.S, but it has a 50% share of the worldwide soda market. We can argue whether soda is growing or not, but Coca-Cola is increasing its non-carbonated water business worldwide, either through acquisitions or through internal R&D.

The major power of Coca-Cola is its distribution network and the global brand name. You can get a cold Coca Cola even in a grass hut in Costa Rica. It is a remarkably powerful brand all over the world, including the big market of China, where the volumes are growing by over 20% a year. The stock market isn't giving Coke much credit for that business as it is totally focused on the execution issues in the US, while we see Coke as expanding its lead or at least remaining strong. We also own Pepsi, and the two companies combined are very strong worldwide and I don't see any signs of that leadership eroding. **T**

Thompson Plumb Growth Fund

Symbol	THPGX
Website	www.thompsonplumb.com
Address	Thompson Plumb Funds 615 East Michigan Street Milwaukee, Wisconsin 53202
Tel. No.	800-999-0887
Inception	02/10/1992

PORTFOLIO	
Total Net Assets*	\$706.5
Avg Mkt Cap (\$ Weighted)*	\$109,600
Average Price/Earnings Ratio	16.94x
Average Price/Book Ratio	3.66x
Turnover Ratio	17%

INVESTMENT INFORMATION	
New Investment	Open
Min Initial Investment	\$2,500
Min Subsequent Investment	\$100
Min Initial IRA Investment	\$2,000

RISK (AGAINST S&P 500 DAILY REINV IX - 3 YEARS)	
Alpha	-0.53
Beta	1.04
R-Squared	0.78
Ann. Std Deviation	8.32
Sharpe Ratio	0.38

RETURNS VS. S&P 500 DAILY REINV INDEX		
	THPGX	Index
1 Year (Cum.)	19.51%	20.59%
3 Year (Ann.)	5.17%	11.68%
5 Year (Ann.)	8.52%	10.71%
10 Year (Ann.)	10.66%	7.13%
15 Year (Ann.)	13.24%	11.19%

RETURNS VS. LIPPER MLT-CAP CORE INDEX		
	THPGX	Index
1 Year (Cum.)	19.51%	20.76%
3 Year (Ann.)	5.17%	13.25%
5 Year (Ann.)	8.52%	12.18%
10 Year (Ann.)	10.66%	7.72%
15 Year (Ann.)	13.24%	11.02%

FEES AND EXPENSES	
Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee	0.00%
Total Expense Ratio	1.12%

PORTFOLIO MANAGER	
John C. Thompson	02/10/1992

*millions

Data through: 06/30/07

Source: Company Documents; Lipper

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