

Value Through Earnings

Investing in growth stocks restricted to U.S.-located and traded businesses is quite a challenging task today, when the US economy is clearly not the growth engine of the world. Edgewood Growth Retail Fund manager Alan W. Breed and his team of portfolio managers face this challenge and look to invest in high-quality, large-cap growth companies when they are trading at very attractive valuation.

Q: What is your investment philosophy?

A: The basic philosophy of Edgewood Growth Retail Fund is to invest in high-quality, large-cap growth companies when they are trading at very attractive valuation. We believe that earnings growth will drive stock prices over the long term.

Since we look at companies as though we are buying the whole business, we seek those that show consistent earnings performance, a proven track record in the market and a strong balance sheet with attractive fundamental valuations. We also look for a competent management that will ensure that this performance will continue in the forthcoming five to ten-year period.

Q: What is your investment strategy?

A: We restrict ourselves to owning U.S. located and traded business and since we look at industries on a global basis, many of the companies in our universe are either U.S. companies that have a significant export business or those that are doing a lot of business in foreign markets.

We are bottom-up investors and we are always fully invested in the market. Since we operate in a tight box, at any one time we will probably have only 45 to 50 growth companies on our radar screen that fit our business criteria – such as companies with low debt, unit volume growth, strong cash flow, and earnings growth.

Our strategy is to identify the best businesses that we can as indicated by balance sheet

strength, predictability of earnings and quality of management team and then create a portfolio of those that show a 20% earnings growth over the forthcoming five-year period. We consider this approach to be a good risk-adjusted process. Therefore, most of our companies are in industries that are growing.

Our investment process is multi-tiered. We evaluate potential candidates by first starting with their current earnings and then grow them out for the next five years. We put a multiple on those future earnings to get what we think the evaluation of the business might look like for the next five years and to bring into account the declining multiple that we foresee in all large-cap companies over this period. We then discount that back at a required rate of return. Our rate of return includes the rate that you get by investing in ten-year treasury and add a risk premium to the earnings predictability. These cash flows are again adjusted for risks.

Next, we rank the companies on a present value basis versus where they are today. Those with the biggest discount to present value are the most attractive and those that are closest to fair value are the least attractive.

Q: How is your research process organized? Where do you get ideas?

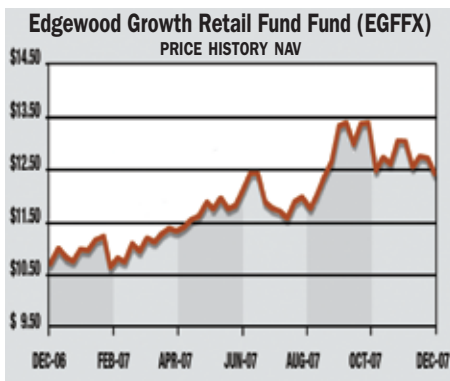
A: Our research process is quite simple. Since we look at any potential investment as though we are buying the whole business, we spend a lot of time studying the industry, the industry participants, and the drivers of the revenue and expenses so that we can come up with an accurate industry growth rate for the future.



ALAN W. BREED is President and Portfolio Manager of Edgewood Management. He joined Edgewood Management, in 1994, as a Partner and a member of the investment committee from First Boston Corporation, where he was a vice-president in the institutional equity department and a member of the firm's Stock selection committee.

In addition to his years at First Boston, Breed worked at Brown Brothers Harriman & Co. where he completed their equity research training program and joined the equity department.

Breed graduated cum laude and was on the Dean's list at Northwestern University's Kellogg School of Management with an MBA. He completed his undergraduate work at Emory University where he graduated with a BA in economics.



Next, we visit every company that we invest in and spend time with customers, suppliers and competitors to understand the business and see how that business fits within its industry so that we can come up with an accurate five-year earnings forecast.

We look at the next five years too. So, zero to five and then look at five to ten as well. This is because when we try to evaluate particularly a large-cap growth company, we are looking at decelerating earnings growth over that period of time, and, consequently, at a multiple that will compress it. We try to discover how quickly that multiple will compress so that when we build our evaluation model, we have an idea of whether this is just a three-year wonder or has longer term sustainability.

We end up with 50 to 55 companies that make our research list. There are screens that we go through looking for companies that grow at a certain rate in earnings in the trailing five years, and have had a 20% price correction that might attract us to consider them. These companies will be ranked top-down. Once on the list, the companies are assigned to one of the six portfolio managers, according to their area of expertise, who form our committee. That person draws up a five-year earnings

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model and presents the idea to the whole committee. The committee then discusses and decides unanimously as a team as to whether or not the idea should be actively followed.

If approved, the idea goes on to the watch list which is then monitored closely. We then do all the due diligence that a private equity firm would to get all relevant data. Then, assuming that the stock is trading at a discount to its present value, and then the team will select the stock for the portfolio.

Q: What exactly are the characteristics that attract you towards a company?

A: Besides looking at fundamentals like balance sheet strength we avoid industries that are based on commodity pricing as we don't feel we can add a tremendous amount of value to forecasting the direction of copper or oil, for example. We are looking for unit volume growth in the industry and in the company that we consider to invest. So, for instance, we are not going to buy Exxon because oil is at \$95 and ExxonMobil is making a lot of money. We might look at alternative energy as a category and do a lot of work to find the companies that are going to benefit as a result of a move to alternative power.

We will not buy airlines because we don't like businesses that are highly regulated by the government or have heavy union exposure. By definition those aren't going to have very good margins and we look for industry-leading margins in industries that have above-average margins. This also implies we look for a good underlying value in the growth stocks that we're invested in.

Q: Can you give an example of how you discovered the underlying value of a potential investment?

A: Corning Inc, where we have a large position. Now, LCD flat-screen technology is changing the world and our research revealed that, though there are many companies in this arena, not all of them are correctly valued. We found Corning, a flat-screen maker that makes 65 % of all the glass used in LCD televisions, as an attractively valued investment.

Corning has two other businesses that are important - fiber optic cable and related equipment and ceramic filters used in diesel engines for pollution control – but we believe that

they are not accurately reflected in the stock price. In fact, they own 50 % of Dow Corning which is worth between \$6 billion and \$8 billion and if they were to ever spin that out or sell that stake and buy back stock, it would be a significant value-enhancing event for the company.

Q: How do you go about constructing your portfolio?

A: At any point of time, we have a strict cap of just 22 companies in our portfolio. Mutual fund rules dictate that to be a diversified fund, we cannot go below 22 positions.

Therefore if you wanted to put say, IBM in the portfolio, you would have to make a case to sell something else and that too from the same sector or group. This is because, while creating it, we try to cut the portfolio on many different dimensions. So one is across industry where we won't allow more than 25% to be in any one industry; the other is across valuation where we don't want our portfolio to have huge multiples.

We divide the portfolio into three classes namely, those that grow 10% to 15%, those that grow 15% to 20% and those that grow 20% and up. We then try to have a balance among the three groups.

Q: Why is this portfolio balancing important?

A: Balancing is essential because sometimes you'll enter certain markets, like in the late 90s where it seemed right to invest heavily in high growth, high-multiple technology stocks because they were going up. Then came 2000 and 2001 where it all went bust in a very short time. We want to avoid such risks by ensuring that we have a portfolio that performs differently. We constantly monitor and try to ensure that we do not have all our eggs in one basket.

Our outlook is long term hence we are able to exploit the short-term wiggles in the market, especially if we believe that we're in a good company with good management and a growing industry. Consequently, our portfolio turnover is closer to 30% or 35 % in a year.

Q: What is your buy-sell discipline? How do you decide how long to let winners run and vice versa with your losses?

A: The winners are tackled on an individual and portfolio allocation basis. Take for example Citigroup (we do not own and have not owned it). Let's say it started as a 4% position but in two years it has gone up 200%, thereby rising to a 12% position in the portfolio. We will never allow it to reach such a large position. We will cut down the position to 6%, the moment it reached 8%, for that's the most we allow in any one given name. We will cut it back every time it hit 8%, meaning we would have cut it back 2% at a time.

Also, if current price hits what we had evaluated as its fair value, we would sell the entire position. Again this decision is made after re-assessing our target price to confirm its accuracy or discover any substantial improvement in the company's fortune.

Losses however, are tackled differently because we get very close to these companies and you have a lot of intellectual capital invested in the idea. However, since we have concentrated positions, losses can really detract from performance and so we are quick to sell.

Let's take the real-world example of Comcast Corporation that we used to own. When Comcast went down 15% relative to its peer group, to remove bias, we reassigned its coverage from the original portfolio manager to another of our partners. That person had 24 hours to come up with an action plan and explain the decline in stock. The original analyst stayed on the committee as an information resource but had no vote on the outcome.

The committee in such cases, discusses the new person's findings and decides whether we should take advantage of the decline and one, buy more, two, sell what we have, or third, just hold on to what we have. In the Comcast case, we felt we had underestimated its competition. They had also missed several milestones in terms of generations of free cash flow and so we elected to sell the stock.

Q: What is the benchmark against which people measure your fund?

A: We are usually benchmarked against Russell 1,000 Growth index but we don't really tie ourselves to it. So, whether it's the S&P 500 or the Russell 1000 Growth we try over a period, to beat every index.

Q: What is your view on risk? How do you manage risk?

A: We are risk averse. So we're averse to market and systemic risks. We are willing to face corporate risk and others that we can analyze, because we've done the research. We can't control what's going on at CitiBank and whether or not they are going to have subprime problems. But we know that all of our companies don't need the capital markets to hit their growth target and over time that's important. Moreover, because we are sufficiently diversified across industry and evaluation class, we are able to weather short term storms.

Stock related risks are the kind we think we can control and manage. For example, we are prepared to take the risk over the fate of Apple Computer's iPhone, because we think we can analyze that. We can see and buy the product, assess consumer demand, and monitor it on a regular basis. Whereas, it is impossible to gauge market reaction to say, subprime lending. We do not take risks that we do not understand or are not comfortable with or cannot analyze.

Q: Can you give some examples to describe how you gain the confidence to take risk of a company's one-product cycle in the forthcoming 5 to 10-year period.

A: Again Apple is a great example. When the first iPod came out, browsing the Internet and visits to all music stores revealed that this was going to be a really big phenomenon and we thought the market was greatly underestimating the long-term growth outlook for iPods. Furthermore, we felt that iPod, being such a good integrated software package, would stimulate growth of iMac. Thus, we had a proven winner like Steve Jobs in the company, an excellent product and an attractive valuation. This is the kind of dream situation that gives great confidence.

Research in Motion is an example where despite the fact that stock price dropped after a patent litigation, we still maintained confidence in that stock. In fact, it has been our largest position for the last two years. We were BlackBerry customers and we realized that they were indispensable to our business. We realized that we were cutting edge in terms of using it and felt that there was a market that currently had a million subscribers which could grow to over 50 million subscribers in ten years from now. 

Edgewood Growth Retail Fund

Symbol	EGFFX
Website	www.edgewood.com
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Tel. No.	212-652-9100
Inception	02/28/2006

PORTFOLIO	
Total Net Assets*	\$0.8
Avg Mkt Cap (\$ Weighted)*	\$49.3
Average Price/Earnings Ratio	32.16x
Average Price/Book Ratio	6.7x
Turnover Ratio	33%

INVESTMENT INFORMATION	
New Investment	Open
Min Initial Investment	\$3,000
Min Subsequent Investment	\$0.00
Min Initial IRA Investment	\$2,000

RISK (AGAINST S&P 500 - 3-YEARS)	
Alpha	N/A
Beta	N/A
R-Squared	N/A
Ann. Std Deviation	N/A
Sharpe Ratio	N/A

RETURNS VS. S&P 500 DAILY REINV INDEX		
	EGFFX	Index
1 Year (Cum.)	21.13%	5.49%
3 Year (Ann.)	N/A	8.62%
5 Year (Ann.)	N/A	12.83%

FEE AND EXPENSES	
Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee	0.00%
Total Expense Ratio	1.50%

PORTFOLIO MANAGER	
Alan W. Breed	2006

*millions

Data through: 12/31/2007

Source: Company Documents; Lipper

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