

Looking for Superior Businesses

Identifying superior businesses with sustained high returns on capital in a universe of small to mid-cap stocks is easier said than done. FPA Perennial Fund manager Eric S. Ende endeavors to do exactly that by adopting a judicious strategy of a company-oriented approach, scrutinizing past track records, and analyzing the businesses to confirm that the company's past superior performance will most likely continue into the future.

Q: What is your investment philosophy?

A: We look to invest in superior businesses with a proven track record of superior and sustained earnings with high returns on capital in the industry. Moreover, we expect them to continue in this vein in the future. Our philosophy is that, by investing in companies that earn a high return on capital and reinvesting the cash flow to sustain growth, we will generate superior long-term investment returns.

We are core style investors that look at small and mid-size companies with market capitalization of as low as \$500 million up to \$10 billion in a universe of 3,000 companies.

Q: Given this philosophy, what is your investment strategy?

A: Generally speaking, we believe that the historical performance is a good guide to the future and our strategy is to begin by looking at a company's past track record when we look for evidence of superiority in a business. However, ours is not a black-box approach where we buy all companies with high returns on investment. We actually analyze the business, the company, and the industry to convince ourselves that the specific company's past superior performance is likely to continue into the future.

Our strategy is to find and own such companies for an extended period of time that will ensure sustained high returns. We

do not want to make money by trading in stocks for short-term gains and miss a large portion of future gains.

Q: What kind of screens do you employ to get a watch list of potential candidates from your vast universe of companies?

A: The fact that we are only looking for companies with high returns on capital as well as sustained returns in the past five years is in itself our quality test or key screen that gets us to a basic list. After that we do screening based on fundamental analysis to find out whether the businesses will continue to be attractive and whether the returns will be sustainable. Finally, we carry out valuation test to assess how much we are paying for these businesses.

Q: How is your research process organized?

A: Again, we begin by looking for companies that have had superior returns in the past, and we also look at numbers such as returns and cash flows. We spend our resources and try to understand the business, the company, the industry, what the competitive environment is like and how it may be changing, and we try to be in a position to figure out whether things will continue to be favorable for the company.

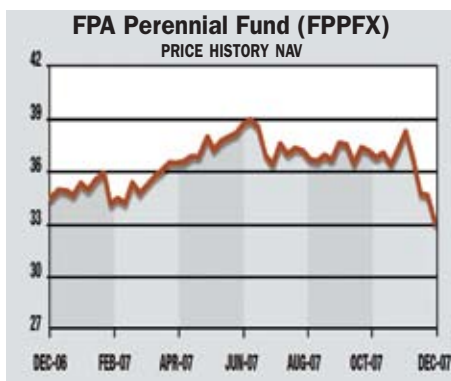
Most importantly, we believe that over time the way a company invests its surplus cash is of great significance to the success of the enterprise. We are not interested in



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During his previous fifteen years, Ende was an analyst for The J. Paul Getty Trust, Occidental Petroleum, and the Ford Motor Company. He earned a bachelor's degree in History (Cum Laude) from Yale College, a master's degree in Modern History (with honors) from Oxford University, and an MBA from New York University.

“We believe that by investing in companies that earn a high return on capital and reinvesting the considerable cash flow in a manner that maintains those returns, we will, in the long run, surpass our competition in performance.”



paying high multiples. Therefore, we tend to avoid the classic growth stocks even though these companies can reinvest all of their surplus cash flow in the core business, resulting in continuing high returns. These companies will not pass our valuation screen.

Consequently, we may have many companies in the portfolio that earn attractive returns but can take only a portion of the cash flow and reinvest it in their existing businesses leaving them with a lot of surplus cash on hand.

We believe that in the long run, asset allocation has a significant impact on the kind of returns shareholders get. Therefore, we are interested in seeing a track record of intelligent reinvestment of this surplus cash flow. This would typically entail making acquisitions. Again, there are certain criteria they must follow. These acquisitions should make strategic sense and be priced reasonably. Alternatively, the company might wish to give it back to the shareholders. That can obviously come as a share repurchase or dividend.

Finally, there might be a company that cannot find reinvestment opportunities and acquisitions at the moment because things that are relevant to them are overpriced or are simply not for sale, and they're willing to be patient. They don't feel the need to go out and do something every week or month or quarter and hence let the cash accumulate.

Q: When looking at small cap stocks, how important do you think is interaction with management?

A: We're not opposed to meeting management, as we believe such interaction can

definitely benefit us. We believe it is a good way of getting to know and understand the business, as management will clearly be more knowledgeable about it. Moreover, with small companies there may be just two or three key individuals that are important to the running of the business and it therefore makes our task easier to know and assess their capabilities and efficiency if we interact with them. However, in the case of large companies, this exercise is not very useful, like at GE or IBM, where although managers are very important, there are usually too many of them.

Q: Can you give us a few examples of holdings you have found to have sustainable high capital returns?

A: A company that we've owned for about ten years is O'Reilly Automotive, which is in the retail car parts business like Auto Zone and Advance. A fundamental difference between O'Reilly and its competitors is that they have evolved from being only wholesalers where they sold to mechanics, to retailing to do-it-yourself individuals. Currently, their business is about 50% commercial or wholesale and about 50% in the retail, do-it-yourself category. That balance gives them many advantages over the retail chains like Auto Zone or Advance Auto Parts, which have around 10% or 15% of their business in commercial or wholesale segment and the rest in do-it-yourself segment.

The first advantage is that they can operate in smaller markets because of their two sources of business. For instance, in a town of 5,000 people or 10,000 people, it may be the only store, giving the company competitive advantages and also allowing for bigger and better inventory levels. This model has proven to be quite successful for O'Reilly and permitted it to expand stores steadily over time. This is a business that can reinvest all of its cash flow internally, and has done so for many years and we expect that to be the case in the future as well.

Currently, O'Reilly is probably the third or fourth largest chain by stores in the country. It operates in the Midwest and to some extent in the Southeast, but is yet to penetrate the Northeast and the West. There-

fore, there are lots of geographic expansion opportunities and it will soon be able to double its business on a store basis.

Another example is Knight Transportation, which we've owned for a number of years. It's in the trucking business where there is plenty of competition. The company was founded by four men all named Knight, who brought with them their work experience at Swift, a big trucking carrier in Phoenix, Arizona, where they had risen to senior positions. They were able to judiciously apply their experience and fresh ideas to run their own business and, we believe, they have done an outstanding job over time. They have adopted a different approach from the usual business that tends to be centralized in authority, by pushing responsibility away from headquarters down to operating people, giving them incentives and motivating them.

Now, in trucking, the operating ratio is a measure of efficiency, which is basically the inverse of operating margins. Hence, if a company has \$1 worth of revenue and 90 cents worth of costs then they have an operating ratio of 90 or an operating margin of 10%. A typical truckload carrier probably has an operating ratio of 95, or around 5% operating margin, while a good carrier might have an operating ratio of 90. Knight, however, has achieved a ratio of 80 over time, which makes them far more efficient than almost all their competitors.

Q: How do you organize your portfolio from the diversification and benchmark perspectives?

A: Historically, we have had a reasonably concentrated portfolio of between 30 to 40 stocks. Currently, the number is 30. We have a very low turnover as we do not have a lot of turnover in names. Our turnover numbers run in the mid to high teens. We are thus looking at long holding periods of five to even seven years.

In terms of portfolio construction we consider the Russell 2500 as our benchmark as it is the closest to our market-cap range. Currently, our median market cap is about \$3 billion. From a benchmark standpoint we tend to ignore sector weightings completely as we do not take a sector

approach to decision-making. We do not know what the Russell sector holdings or weightings are and do not care if there are sectors where we own nothing at all, especially if we think they are bad industries or businesses. We thus do not track index returns well.

Our portfolio is well diversified because, historically, we have found sustainable high return businesses over a wide range of industries. Therefore, even though the portfolio may not have any financials, chemicals, or other commodity-related stocks, and has relatively low weighting in high growth areas, we have acquired many names from different industries in our portfolio.

Again, as mainly individual companies form our portfolio, we may often select companies that are in identical businesses. However, if retailers suddenly become cheap and if we liked five names and added them to the list of retailers we have in the portfolio we could have a large exposure to the industry. We do not let this happen. Since we know what we're buying and what we're selling, if suddenly the weighting is tilting too far in some direction we just stop it. Moreover, we do not consciously look to add companies from a sector just because it is underweighted in our portfolio even if it is not as good as we normally like.

Q: What is your buy-sell discipline?

A: Generally speaking, we prefer to buy stocks that are going down in price and tend to sell those that are going up in price.

Selling is harder as it is mainly based on valuations. Higher valuation would certainly be a reason to either reduce the position size or eliminate it completely and replace it with another of equal quality that is much lower priced. But we are not always sure whether our view of their comparable quality is really justified. This is because we are replacing companies we had bought at a reasonable price, owned for many years and know quite well, with less familiar companies.

Therefore, high valuations can sometimes be misleading, especially if the company continues to perform in an outstanding

manner. Then maybe it will maintain that high price-to-earnings ratio.


The other reason for selling is because the stock is not as good as it used to be in terms of company quality and business dynamics. This may be due to competitive changes in the market or management changes, or because we just made a mistake and bought something that is not as good as we thought, or that it never was any good and it is just that we had only recently figured that out.

Q: How do you control risk?

A: We try to be fully invested and we are not particularly concerned about market risk. Like in the case of sectors, we also do not make macro-driven decisions. We just take into account the macro view of stock markets and look for individual companies with superior operating financials and reasonable valuations.

Our key view on risk is that we own businesses that earn superior returns with leading market shares, high operating margins, good cash flow and relatively unleveraged balance sheets. Therefore, such businesses ought to be less risky over time, assuming their valuations are not particularly higher than stocks as a whole.

Furthermore, in case of an adverse economic environment, we believe such businesses with lots of cash flow and strong balance sheets will actually be in a better position than their competitors. They can continue to invest in new product development and in marketing, perhaps making acquisitions of weakened competitors and, even if in such an adverse environment, their profits or stock price is down, when the situation improves, they are better off than when they went in. Such companies that benefit from adversity too are common members of our portfolio.

In terms of portfolio risk, since we research each stock individually, we end up with a considerably diversified portfolio that takes care of any risk that arises on that end. We are also debt averse and avoid companies whose balance sheets or income statements show big debt numbers and huge interest expense numbers. 

FPA Perennial Fund

Symbol	FPPFX
Website	www.fpafunds.com
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Tel. No.	800-982-4372
Inception	04/02/1984

PORTFOLIO	
Total Net Assets*	\$391.2
Avg Mkt Cap (\$ Weighted)*	\$4,000
Average Price/Earnings Ratio	20.37x
Average Price/Book Ratio	3.04x
Turnover Ratio	16%

INVESTMENT INFORMATION	
New Investment	Open
Min Initial Investment	\$1,500
Min Subsequent Investment	\$100
Min Initial IRA Investment	\$100

RISK (AGAINST S&P 500 DAILY REINV - 3-YR)	
Alpha	0.01
Beta	0.90
R-Squared	0.53
Ann. Std Deviation	9.60
Sharpe Ratio	0.56

RETURNS VS. S&P 500 DAILY REINV INDEX		
	FPPFX	Index
1 Year (Cum.)	7.10%	5.49%
3 Year (Ann.)	7.93%	8.62%
5 Year (Ann.)	15.05%	12.83%

RETURNS VS. RUSSELL 2000 GRO TR INDEX		
	FPPFX	Index
1 Year (Cum.)	7.10%	7.05%
3 Year (Ann.)	7.93%	8.11%
5 Year (Ann.)	15.05%	16.50%

FEES AND EXPENSES	
Max Sales Charge - Front	5.25%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee**	2.00%
Total Expense Ratio	0.91%

PORTFOLIO MANAGER	
Eric S. Ende	1995

*millions **within 3 months after purchase

Data through: 12/31/2007

Source: Company Documents; Lipper

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