

Unemotional Search for Steady Growth

James McCarthy, the manager of the Seascap Focus Growth Fund, believes that his fund has the process and the discipline to early identify companies that will grow faster than the market. Objectivity, or the lack of bias and emotions, is a key feature of the strategy that aims to pinpoint the best 30 growth stocks to own. Based on previous experience with private accounts, the fund aims to expand Seascap's reach beyond the high net worth investors.

Q: What is your investment philosophy in managing the Seascap Focus Growth Fund?

A: We manage the fund with the belief that we can identify companies that will grow faster than the market. Those companies tend to have certain identifiable characteristics in common. We believe that if we stick to those types of companies, the fund will outperform the market.

We focus exclusively on the fundamental characteristics of the companies to put together a relatively concentrated portfolio that still provides diversification. Overall, we want to own the best thirty companies in terms of earnings, growth rates in earnings and multiples to earnings, and the companies that are able to sustain those characteristics.

The fund was established in August, but we have run this strategy for almost five years for separately managed accounts. We set up the fund with the idea to increase the availability of this successful strategy beyond just the very high net worth individuals.

Our approach is long-term oriented. Once we put a company into the portfolio, we want to give it at least a year to realize its potential. Since the genesis of the firm is working with high net worth individuals, we initially wanted to make sure that our gains

were taxed at a lower rate. However, we did examine shorter holding periods but didn't find enough value added to offset the additional risk and transaction costs. So there is an element of tax efficiency in the process, but it is a byproduct of our discipline.

Q: Why do you believe that building portfolios with only 30 stocks is a viable strategy?

A: I believe that a 30-stock portfolio provides 95% of the diversification benefit. According to a 1970 study of Fisher and Lorie, to get a greater diversification benefit, would require quadruple the number of holdings. We believe that if we own more companies, we would dilute our portfolios with lesser quality companies than our top 30.

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

A: We have a disciplined process that is focused on the financial fundamentals of the companies. We start with a universe of about 8,500 domestic U.S. companies, including ADR's. We exclude the companies with market capitalization of less than \$1 billion for liquidity reasons, as well as the companies with negative annual earnings growth, poor sentiment, and low trading volumes. Overall, we want to be able to buy these companies without drastically moving the price.



JAMES W. MCCARTHY founder, President and Chief Investment Officer of Seascap Capital Management, LLC, crafted, implemented, and now oversees the firm's investment strategy. Through extensive research and analysis, he developed Seascap's investment selection criteria and quantitative models.

Prior to founding Seascap, McCarthy held the titles of Senior Vice President, Senior Portfolio Manager, and Senior Investment Management Consultant at a leading Wall Street firm. For nearly two decades, he focused on providing discretionary portfolio management to high net worth clients.

Jim currently consults to numerous boards that manage funds in a fiduciary capacity and is a member of the Investment Management Consultants Association (IMCA), the International Board of Certified Financial Planners and the Registry of CFP Practitioners. In addition to earning his CFP from the College for Financial Planning in Denver, CO, in 1988, The Wharton School at the University of Pennsylvania conferred on McCarthy the Certified Investment Management Analyst (CIMA) designation in 2001.

“We focus exclusively on fundamental characteristics to put together a focused portfolio that creates the best balance between upside potential and diversification. Overall, we want to own the best 30 companies in terms of earnings, growth rates, PEG and P/E ratios—no more, no less.”

We then apply our multi-factor ranking criteria and each company receives a composite score. The main factors are the projected growth and what we want to pay for that growth. Then we look at the valuation versus other types of investments to make sure that on a risk-adjusted basis, the investment is worth considering. We also look at the predictability and the sustainability of that growth. The relative strength is important to make sure that there's institutional support for the stock.

We apply those factors across the entire subset without making any adjustment for industries or sectors. Then we go through qualitative evaluation of the top-ranked companies to make sure that we didn't miss something that might not be captured in a quantitative score. Such factors can be management changes and corporate activities, such as mergers and spin-offs, for example.

Then, for risk management purposes, we limit the number of the companies in any particular industry to no more than five. So although we don't apply any macroeconomic overlay to our sector weighting, we still limit the sector risk. Then we take the top 30 stocks from that universe and buy them for the portfolio. Our objective is to hold them for at least a year, unless there is a corporate action or a fundamental change. This is to make sure the portfolio is tax sensitive.

Q: Do you consider the dividends or the growth of the dividends when selecting the stocks?

A: This is a growth strategy, and we are not adverse to dividends, but they are not one of our screening criteria. We believe that we can identify companies that are growing quickly, while a company that pays dividends usually does so because it doesn't have anything better to do with the money. Of course, dividends can add value to a portfolio, but they are not part of our focus and screening process.

Q: Why have you chosen the market cap threshold of \$1 billion? Do you have a preference for companies of specific size?

A: We avoid companies with market cap of less than \$1 billion for liquidity reasons, but that's the only restriction we have. In that way we do get the top end of the small-cap market, as well as the mid-cap and large-cap universe.

I believe that one of the benefits of this approach is that we are led by the financial fundamentals rather than by a certain market-cap range. Overall, we have a portfolio of 30 equally weighted stocks and we don't make any particular bets. Although we employ a bottom-up strategy, we don't favor any of the 30 companies in the portfolio. We simply take the companies that screen most favorably for us.

We correlate most closely with Russell 3000 Growth Index, but that's not a high correlation because we have a bottom-up process, and we're not trying to match sector weightings.

Q: Could you give us any specific examples of stock picks that illustrate your process?

A: Three years ago we managed to buy early, Research in Motion which made it through our screens. At the time, you wouldn't have considered it a good company to own because there were at least four other players in that market that were cannibalizing each other's business. And that stock tripled for us in a year.

Also, we bought Apple's stock three years ago, which was quite early. We had very healthy return on that stock and we held Apple for more than two years. I believe that the stock jumped six or seven times from our purchase price.

These are examples of stocks that might not have made it into the portfolio for subjective reasons. The prior experience, the analyst estimates, and the general feelings about them were negative at the time. Our objective process, however, allowed us to identify them early because they met our criteria. Often some of our best holdings with the highest returns have been exactly the companies that investors would have avoided based on emotions or misconceptions. This underscores our confidence in the unemotional ranking system that we use to grade some companies.

Q: What would you do when, after selling a stock, it still doubled and tripled? Also, would you reconsider stocks that you have sold if they meet your criteria later?

A: We don't really worry about what happens to a stock after we sell it because, usually, we've replaced it with a company that ranks higher and more closely fits our criteria. As long as we've held the stock at least for a year and, we have made long-term gains, we're very confident when we finally do replace the stock for a better opportunity.

Of course, we would reconsider stocks in certain cases if they were to screen in our top 30 at the times we are rebalancing. We don't think that the companies necessarily go straight up year after year. Often they get a bit ahead of themselves, and then flatten out. If they're the type of companies that keep growing, they may pick up in the following year.

Q: How often do you change or modify your screening process?

A: The original screening process is almost identical to the current one as we have made only minor improvements. We make changes only after we test some-

thing over an extended period of time and we know that it significantly improves our process.

We are looking constantly for ways to improve the process, and we run many different tests, scenarios, and stress tests to determine whether a change might add value. So far, in almost every example we've looked at, there has not been enough value added to offset the additional risk, the volatility, or the transaction costs involved.

Q: What is your buy and sell discipline?

A: We put the portfolio together from the results of our screening process and we build it with equally-weighted stocks. We may make changes to the portfolio at the end of the year to take tax losses. We would replace stocks if there's a takeover or significant changes in the company that we bought. We wouldn't buy companies that are in the process of being acquired or companies for which we know that a takeover is imminent.

Later, when we re-run and re-rank the universe, we look for the stocks with the highest growth opportunity. If a stock screens well again at that point, we will cut it back to an initial position and continue to hold it. But if it doesn't screen well, we'll replace it with something that potentially has more upside. So selling stocks is typically the result of finding better ideas.

Q: In the high-growth universe, there is a point when the companies start to miss the earnings expectations. What do you do in those situations?

A: As I said, we would give our holdings at least a year and we wouldn't be worried if they missed the estimates in a quarter. All the companies, especially the fast-growing companies, occasionally miss expectations, but that doesn't make them poor companies. If our evaluation of the other characteristics tells us that there is a good chance for the company to be back on track in the next quarter, we'll remain committed to that company.

More importantly, we have valuation factors embedded in our ranking system. So we invest in companies where the valuation is not too extended and the expectations aren't too lofty. When executing the trades, we also use technical overlays to limit the risk and make sure that we're not paying too much even for undervalued companies.


Q: How do you approach the risk control? What type of risk do you monitor and guard against?

A: We believe that our risks are mitigated at the portfolio level by having enough diversification. The equal weight means that no company has an overwhelming effect on the portfolio. Through our process, we tend to find the more healthy companies, so we aren't too worried about the stock-specific risk.

The sector risk is mitigated through the limit on the number of securities in one industry, which results in maximum industry exposure of approximately 16.5% at cost. We also monitor our holdings for changes, such as takeovers, to make sure that we still own the same companies that we initially purchased.

Q: Generally, the fast-growing companies depend on their product cycle. Do you spend a lot of time in understanding the product cycles or you rely mostly on the financial performance?

A: We look primarily at the financial performance. When we look for positive earnings changes, we may find a company that's moving from negative to positive earnings, and it doesn't require a great deal of time to know that they're well into the product cycle.

Our criteria also include relative strength over different time periods, and we can identify if the relative strength is starting to wane, if it is steady or increasing. So our process tends to eliminate the companies for which the relative strength is becoming a problem. Since we are looking at the earnings two and three years out, if the product cycle is starting to fade at the end, it will be factored in the valuation of the company. 

Seascope Focus Growth Fund

Symbol	SEARX
Website	www.seascope-capital.com
Address	Seascope Capital Management 155 Lafayette Road Drake Hill Commons North Hampton, NH 03862
Tel. No.	877-724-5726
Inception	07/31/2007

PORTFOLIO

Avg Mkt Cap (\$ Weighted)*	\$8,300
Avg Price/Earnings Ratio	21.61x
Avg Price/Book Ratio	4.64x
Turnover ratio	N/A

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$2,500
Min Subsequent Investment	\$100
Min Initial IRA Investment	\$250

FEES 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

James McCarthy	2007
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*millions

Data through: 02/29/2008

Source: Company Documents; Lipper

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