

## Values in Growth

*The ability to see beyond the next few quarters, and focus on what a company's long-term growth can be, allows Roxbury's Strategic Growth portfolio to exploit short-term investor biases. Using a disciplined, consistent and patient investment process, lead portfolio manager Brian Massey looks for durable large-cap franchises that can grow excess returns on capital into the future, yet trade at significant discounts to the firm's estimate of their true worth.*

**Q: What is your investment philosophy?**

**A:** We look for those rare durable growth businesses with a wide "economic moat," or sustainable competitive advantage, and abundant opportunities to grow and reinvest capital at high rates of return. However, and just as importantly, we will only buy a business when we feel we are getting it at a reasonable discount to its true worth. I guess you could call us value-based growth managers. For us, growth and value are inseparable. Identifying those stocks with valuations representing a good margin of safety is just as important as identifying a business that can grow shareholder value well into the future.

**Q: What do you think drives the stock prices over the long term?**

**A:** In our minds, it's the growth of shareholder value, not just earnings per share, that drives stock prices over the long-term. This definition of growth is different from most managers that just focus on earnings or revenue growth. A company creates value by generating a return on capital that is greater than its cost of capital. Over the long term that spread is what determines the value of a business, and ultimately, its stock price.

Just looking at EPS, in our opinion, misses half the story. How much capital is re-

quired to generate that earnings growth is just as important. Looking at the world with this more complete picture broadens our universe and gives us a truer perspective on the real durable growth franchises that are out there. Plus, we often uncover a lot of unique growth businesses that many growth managers would overlook.

**Q: Who are the typical clients of your strategy?**

**A:** We have a combination of high net worth individuals and institutions. Given our historically low turnover, the portfolio tends to be fairly tax-efficient, which is important to many clients.

**Q: Do you have a minimum required investment?**

**A:** We generally require at least \$1 million for our separately managed accounts, though we sometimes lower this by special exception and through the sub-advisory platforms we are part of.

**Q: Could you highlight your investment process?**

**A:** We put each company through the same process, regardless of the business model or what sector it is in. Every time we look at a company, we ask a series of questions. What is the moat around this business? What are the future cash flows? How much are we will-



**BRIAN MASSEY** CFA, joined Roxbury Capital Management in 1996 and was promoted to the role of Director of Research, in 2002. He is currently the lead manager of Roxbury's Strategic Growth portfolio and co-manages the firm's other large-cap growth products, all of which have outperformed their benchmarks under his leadership.

Before joining Roxbury, Massey was a senior consultant with KPMG Peat Marwick's strategic consulting group. He has an undergraduate degree from Johns Hopkins University and an MBA from the Anderson School of Business at UCLA.

ing to pay today for those cash flows? How are we different from the consensus? What is the downside if we are wrong about the future? How does this stock fit into the overall portfolio? If we are right on our projections a majority of the time, we will be providing a valuable service to clients.

There are basically four criteria for every stock that goes into our portfolio. First, it needs to be able to grow shareholder value over the long-term. As we discussed, that doesn't mean it must grow EPS at some minimum rate, but rather it must expand profits relative to invested capital over time.

Second, we will only invest in businesses with "wide-moats," or some protection around their franchise that should allow them to generate excess economic returns well into the future. This moat can take many forms, but it's usually something structurally that gives the company a permanent cost advantage, requires a significant lock-in for customers, or represents some intellectual property that keeps the competition at bay.

Third, we will only invest in management teams that have proven to be good capital allocators. Many management teams are just focused on growing revenue or earnings at the cost of eroding returns on capital. We do extensive work in adjusting accounting statements to reflect economic reality. Ultimately, the histori-

cal numbers don't lie and are an excellent report card to see if management really does what they say they do.

These first three criteria whittle our universe down to 150 or so companies. These are those truly rare business models in which we have a high level of confidence that in five years or more they will still be generating excellent returns on capital. The next step in our process is to figure out what these businesses are worth. To do that, we employ various valuation metrics, with discounted cash flow metrics being the most important.

We run a lot of different scenarios and apply probabilities to those to come up with a probability-weighted value. We aren't naïve to think we are going to know exactly what the future holds, so we look at various scenarios, both bullish and bearish, and determine what the likely upside and downside is. We want to stack the odds in our favor and maximize our payout while minimizing our potential losses.

**Q: How is your research process organized?**

**A:** Our research team is made up of seven people, each of whom has some industry specialization. We think that the cumulative knowledge built up by covering an industry for years, understanding the management teams, business models, and product cycles is a very important competitive advantage for us. Most of us have been covering our industries for a decade or more. We can use that deep fundamental understanding when the market is panicking about an issue we don't consider to be that important to the long-term growth of the business.

Given the strict criteria we talked about, we are only looking for each team member to identify two or three really fat pitch ideas a year. Our objective is not to find just any stock that can go up over the next 3, 6 or 12 months. It is to uncover those rare durable growth franchises, fig-

ure out what they are worth, and then just wait, years in some cases, until we get a chance to buy the stock on sale.

**Q: Can you give us some historical examples of this process in motion?**

**A:** Let me begin with The First American Corporation (FAF), a title insurance company. Title insurance is a terrific business, albeit cyclical. Pricing is determined by state insurance regulators who also control licensing requirements, further protecting First American's franchise. The title insurance segment, which makes up about half of the company's profits, is declining in importance as its higher-growth, higher-margin real estate information services ramp up.

First American has leveraged its competitive moat—the most complete collection of mortgage and property data available to lenders or brokers—and transformed itself into a real estate information services provider.

It is amazing to us that a lot of investors categorize title insurers as "value" stocks. First American has compounded revenues, earnings, free cash flow, and book value at rates in the high teens over the last decade, while expanding returns on capital to as high as 25%. This is a huge amount of underappreciated shareholder value growth.

Looking forward, we think the company is just beginning to leverage this database of information, which could prove to be very lucrative over the next 10 to 20 years. There is very little competition and few that could replicate the business model First American has built. Despite this terrific growth potential, the company only trades at 12 times free cash flow. Management has renewed its focus on unlocking the inherent value that the stock price doesn't reflect. They have only begun to optimize the company's operating structure.

**"For us, growth and value are inseparable. Identifying those stocks with valuations representing good margins of safety is just as important as finding those businesses that can grow shareholder value well into the future."**

**Q: Can you give us another example?**

**A:** Cooper Companies is a contact lens manufacturer that was a dominant player in the specialty contact lens market. In late-2005, the market shifted to a new, more comfortable material called silicone hydrogel. Cooper completely missed this product cycle as it was still perfecting the manufacturing process for the new lens. As a result, the stock went from low \$70s all the way down to low \$40's because the company lost share and chronically missed and lowered estimates.

As we did our research and understood the hurdles facing Cooper, we believed it was a question of when, not if, it would launch its own silicon hydrogel lens. Whether it took six months or two years, the revenue growth, margin expansion and free cash flow growth justified a much higher stock price. Even if it required waiting two or three years to realize our estimate of fair value, we would generate an excellent return on our investment, while at the same time exposing ourselves to very little downside.

We took further comfort in the fact that Cooper is really the last independent contact lens manufacturer. There are a handful of companies that would love to enter this great growth business, so Cooper is a valuable asset. In a worst-case scenario, we felt Cooper would be acquired at prices well above those we were investing at.

As it stands today, the story still hasn't played out yet. We think Cooper is only months away from launching its new lens, which should drive accelerating revenue and cash flow into 2008 and beyond. Once the manufacturing risks are behind Cooper, we also think potential acquirers will take a closer look at the company.

**Q: How do go about constructing the portfolio?**

**A:** We keep the portfolio relatively concentrated with 30 to 50 companies. We build the portfolio using a fundamental bottom-up process, filtering ideas one-by-one through the lens I discussed earlier. Any sector allocations or market timing decisions are purely residual effects of this process. Turnover has generally been below 30% and the top 10 positions normally make up about 30% of the portfolio.


**Q: Do you measure yourself against any particular benchmark?**

**A:** We are benchmarked against the Russell 1000 Growth Index. Our portfolio characteristics, like expected earnings growth, stack up favorably next to the index, though our strategy typically has had much less volatility despite better returns than the benchmark.

**Q: What is your sell discipline and how do you monitor and mitigate risk?**

**A:** On an individual stock basis, we think that the best way to control risk is to pay the right price in the first place. When you buy stocks at a discount, even if you're wrong, capital loss will be minimized. Preservation of capital is very important to us. Avoiding losses is crucial.

Stocks are typically sold or trimmed when they approach our estimate of fair value, when the original thesis is altered, upon seeing a change in the fundamentals, or to make room for better ideas in the portfolio.

Stocks are reviewed on the basis of any price weakness, defined as a drop of 10% from cost or 20% from a recent high. Such activity may be an indication of important fundamental information making its way into the marketplace. More often than not, price weakness is often an opportunity to add to a long-term position. 

**Roxbury Strategic Growth Strategy****COMPANY FACTS**

Website	<a href="http://www.roxcap.com">www.roxcap.com</a>
Address	Roxbury Capital Management, LLC 100 Wilshire Blvd. Suite 1000 Santa Monica, CA 90401
Tel. No.	310-917-5600
Inception	2002

**PORTFOLIO**

Total Net Assets*	\$75
Avg Mkt Cap (\$ Weighted)*	\$56,400
Median Mkt Cap *	\$22,300
Median ROE	19%
P/E (1-Year Forecast)	18x
(P/E) / (EPS)	1.3x
Average Price/Book Ratio	3.3x
Yield	1.1
LT Debt/Capital	25%
Turnover Ratio	23%

**INVESTMENT INFORMATION**

Min Initial Investment	\$1,000,000
Min Subsequent Investment	N/A
Min Initial IRA Investment	N/A

**RISK (AGAINST RUSSELL 1000® GROWTH IX- 3 YEARS)**

Alpha	2.70
Beta	0.65
R-Squared	0.77
Ann. Std Deviation	6.37
Sharpe Ratio	0.82

**RETURNS VS. RUSSELL 1000® GROWTH INDEX**

	Rox Str Gro	Index
1 Year (Cum.)	9.5%	7.1%
3 Year (Ann.)	8.6%	7.0%
5 Year (Ann.)	5.3%	3.5%

**PORTFOLIO MANAGER**

Brian L. Massey, CFA  
Silas A. Myers, CFA

\*millions

Data through: 03/31/07

Source: Company Documents

**Ticker conducts interviews with managers of investment products, analysts, and senior executives to provide insights into various investment areas, and the strategies and tools to be employed.**

**Additionally, Ticker uncovers consistent and outperforming mutual funds through its FundScreen interviews.**

**You can read more Management-Talk and FundScreen interviews at Ticker.com**