

# Capturing Growth

**A** growing company of yesterday is not necessarily a growing company of tomorrow. Mark Baribeau, co-portfolio manager of the Loomis Sayles Growth Fund, is fully aware of how dynamic business and the stock market is, so his fund aims to capture the growth phase before it gets fully priced into the stock. Looking for rapid, fundamentals-based growth with a structured approach, he can find it in virtually any type of business.

**Q:** Would you describe the investment philosophy of your fund?

**A:** We (Baribeau along with co-portfolio managers Richard Skaggs and Pamela Czekanski) firmly believe in owning stocks of businesses that are growing rapidly, have defensible competitive advantages, and are exploiting good market opportunities. Stocks perform best when the companies are going through a strong growth phase with barriers against competition, so that profit margins are expanding and return on invested capital is accelerating.

We're very active investors. We don't mind taking big bets against the benchmark or the market itself. We let the process tell us where we should focus as investors rather than picking stocks from the index components. We're looking for profit growth no matter where we find it.

In the last three years growth stocks haven't done that well on average, but active managers have done very well as there's been a whole new group of companies coming along with strong fundamental leadership. These new leaders are not the ones from the 1990s, which happen to dominate most of the indexes. So it's been a very interesting time for the good stock pickers.

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

**A:** The process involves three steps. First, we run quantitative screens looking for a minimum of 11% per year EPS growth for the next three to five years.

Second, we'll look for positive earnings revisions after a company has reported fundamental news. If analysts' consensus has been far too conservative regarding the earnings power of a company, you'll see that reflected in an upward revision for this year and the next year. That's an indicator that a security may be systematically undervalued because analysts have been too conservative in their profitability estimates. We track that every month as an indicator to take a look at the stock.

Another key element is looking for strong or accelerating revenue growth. We don't want to be weighed down by companies with sluggish sales growth that are driving their earnings up through cost cutting or financial restructuring. If strong unit demand is backing the sales growth, then the earnings estimates are more likely to be sustained over time.

Once we've gone through that process, we'll take a look at the valuation to decide if it isn't too late to buy

## Loomis Sayles Growth Fund

### Fund Facts

Symbol	LGRRX
Website	<a href="http://www.loomissayles.com">www.loomissayles.com</a>
Address	Loomis Sayles & Company, L.P. One Financial Center, Boston, MA 02111
Tel. No.	800-225-5478
Inception	1/2/1997

### Portfolio

Total Net Assets *	\$ 269.5**
Avg Mkt Cap (\$ Weighted) *	\$ 61,500
Average Price/Earnings Ratio	26.39
Average Price/Book Ratio	6.29
Turnover Ratio	171 %

### Investment Information

New Investment	Open
Min Initial Investment	\$ 2,500
Min Subsequent Investment	\$ 100
Min Initial IRA Investment	\$ 1,000

### Risk

Ann Std Deviation	13.01
Sharpe Ratio	1.07

### Returns vs. Lipper Large-Cap Growth Index

	LGRRX	Index
1 Year (Cum.)	14.39 %	12.21 %
3 Year (Ann.)	16.03 %	11.03 %
5 Year (Ann.)	-0.50 %	-4.36 %

### Returns vs. Russell 1000 Growth Index

	LGRRX	Index
1 Year (Cum.)	14.39 %	9.73 %
3 Year (Ann.)	16.03 %	10.68 %
5 Year (Ann.)	-0.50 %	-4.14 %

### Fees and Expenses

Max Sales Charge - Front	5.75 %
Max Sales Charge - Deferred	0.00 %
Max Redemption Fee	0.00 %
Total Expense Ratio	1.10 %

### Portfolio Manager

Mark B. Baribeau	Apr-1999
Pamela Czekanski	Jan-2000
Richard Skaggs	Jan-2000

\* millions \*\* all share classes

Data through: 11/30/05

Source: Company Documents; Lipper



**TICKER'S Choice**

the stock. We use discounted cash flow models to determine the intrinsic value of a company and what the market is already embedding in this security. Other methods of valuation, including P/E ratios, tell you what a company is worth, but they don't tell you why it's worth that relative to any other competitor.

The third step in the process is risk management, which helps us determine the position size we should establish in a stock.

**Q:** *What are the milestones in terms of portfolio construction and risk management?*

**A:** There are three variables that help us determine the position size we should establish in a stock. The first one is the volatility of the historical stock price that will influence the level of the allocation we make. The second is the correlation of similar risk factors embedded in that security with other stocks in our portfolio. The higher the correlation, the lower the position size we're likely to take.

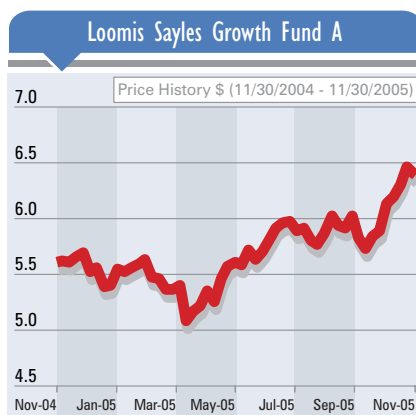
Third, we match our fundamental conviction level with the position size. Even if a stock is not very big in the market, it may come in as a large holding in the portfolio if our conviction level is very high, the stock has unique non-correlated risk factors versus the rest of the portfolio, and a unique business model with very little competition.

The risk management part of the process is important as the last filter in terms of building the portfolio. We always stay fully invested. Cash will only go to a maximum of 5%. A single position in the portfolio can grow only to 5% of the portfolio's market value and then we'll start selling it.

We only have 45 to 55 stocks. The turnover historically is about 175% and that's where the active manager discipline comes in. The turnover is not due to new names; half of it is trimming from or adding to existing positions.

**Q:** *Since you define growth based on projected earnings, there is always the factor of guessing and hoping. At the same time, historical earnings are a fact, but they aren't necessarily reflecting the direction in which the company is going. How do you handle this situation?*

**A:** We definitely look at historical earnings because they help to establish the execution profile of the business, whether it's a growth business or not, how well the company executes versus its peers, whether it's gaining or losing share. All of these are important in evaluating the investment case.



What we don't do is top-down macro bets. We don't get involved in economic forecasts that could disrupt or change, because the business dynamics is not forecastable. Instead, we focus on the individual business and how the company is executing in the current environment, because this is the best indicator of what could happen in the next three to 12 months. While all valuation models are based on long-term forward cash flows, the reality is that short-term stock performance is based on very short-term fundamental results.

**Q:** *Active management also creates some tax liability for the investors. Is that something that you manage or the tax implications are just part of the fund?*

**A:** Yes, it's something that comes with the fund. Given the bear market of

five years ago, there's still a lot of tax loss carry-forward in the fund. The tax issue should not be a major concern for investors for a couple of years to come.

**Q:** *So why would you use the discounted cash flow, which requires assumption of interest rates and a longer-term view of the earnings stream?*

**A:** Once you understand what is built into the valuation structure of the security, let's say 18% growth, then you look at the company. If you see that it isn't even capable of achieving 15% growth in the next three or five years, then you know that it's overvalued. Otherwise you need a place to start, which you can break down by assumption and test whether there's upside in the security. Every equity price is based on the long term value of the business, it's not based on the short term. Whether it works as a stock in your portfolio, however, is a function of the short term.

**Q:** *Do you create your own estimates or do you rely on Wall Street estimates?*

**A:** When we're tracking earnings revisions, we're only interested in the consensus. Once we've looked at the revisions, we drill down and look at the quality of earnings, the accounting adjustments, and the tax rate assumptions that may be changing. We want to know if it's just an accounting-based earnings revision or a fundamental revenue-based change. If the quality of earnings looks good, then we'll take a harder look at the fundamental drivers, create our own earnings estimates, and decide where we think the business is headed. The revisions are a signal that we should take a harder look at the business because it may be undergoing an inflection.

The best example of that case is Apple Computer, which we bought in the middle of last year. Apple was a stock we've never owned before. The company has a history of great product

innovation and it has struggled to maintain consistency in execution, but it has been working hard to get going again. The earnings revision was significant and was indicating that a big change was due in the profitability of the business.

It looked inexpensive on a valuation basis, while at the same time it had a robust profit outlook. So it became a compelling buy and there's no way we'd have picked up that idea if the first earnings revision didn't focus our attention on the change in business dynamics at the company.

**Q:** *Do you worry that the enthusiasm over a stock like Google could be reflected in the multiple and you may overpay for its earnings? If earnings disappoint in a quarter, the stock would suffer for a while. Would that be an opportunity to buy more or you would take your profit and run?*

**A:** In most cases, if a company misses its numbers, this is an opportunity to take profits. In the case of Google, which has been a very robust stock, it means that it's priced for good news, not for bad news. And the initial adjustment in the price will never be the last adjustment. It will seem painful that day, but in reality, it's a great selling opportunity. You need to let the stock underperform for some time before it forms its base on positive news and becomes a buy again. The downside is always far bigger than people estimate on the first piece of bad news, so such cases are a selling opportunity for us.

Ideally, you'd have taken profits as the stock has worked over time; you'd have trimmed your position and locked in excess return. If you don't get bad news as truly unexpected and there's been no deterioration in the business truly unexpected, then it's a matter of just controlling the risk. Selling on bad news is your first opportunity to fix the performance problem and your performance problem is to last for one

hour instead of for the next 12 to 18 weeks if you're stubborn.

**Q:** *How is your research process organized? How an investment idea becomes a holding?*

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about

Mark Baribeau

**Mark B. Baribeau, CFA**, is vice president and portfolio manager for Loomis, Sayles & Company, L.P. As chief investment officer of Loomis Sayles Large Cap Growth Group, Mark and his team oversee \$6.9 billion in institutional and retail portfolios, including the Loomis Sayles Growth, USAA Growth, USAA First Start Growth and the IXIS Loomis US Large Cap Growth Funds.

Prior to joining Loomis Sayles in 1989, he was an economist at John Hancock Financial Services. Mark earned a BA at the University of Vermont and an MA at the University of Maryland. He is a member of the Boston security analysts society and national association of business economists.

**A:** We have 14 equity analysts who cover the major sectors of the market. They're actively covering over 600 companies, so that's where the focus is. As our process uncovers new names, we'll bring them to the research group to pick up coverage, so they're actively covered.

We only look at companies with market cap of more than \$3 billion, so the list changes every year. If there's something that needs more attention because of the uniqueness of the fundamentals, our analysts will pick up coverage and we'll add it to the list.

**Q:** *Can you describe your sell discipline in more detail?*

**A:** The sell discipline comes in two buckets. The first one is risk management, where selling occurs because the stock is approaching a price target and we're trying to lock in excess return. The odds are that we'll trim the position rather than sell it entirely.

The second bucket occurs because of the potential for deteriorating return. We're trying to get in front of negative earning surprises, so we look at balance sheet deterioration and quality of earnings deterioration. These would indicate that the company is stretching to make the numbers and is likely to miss earnings, so we try to get out beforehand by selling.

The rest of the fundamental-based sales occur due to negative developments, such as a weakening of the competitive position as new products come to the market, a product-specific issue, a failure of an expected catalyst to materialize, or a change in the management that we don't like. For example, if an important new drug product is pulled from the market or not approved by the FDA, that's an obvious disappointment that's going to negatively impact the earnings profile going forward. We also have a stop loss - if a stock declines by 25%, we trim or eliminate it. ■

**TICKER Staff**

## Disclosure Statement

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	Cumulative (As of 3/31/06)	Average Annual Returns (As of 3/31/06)		
		YTD	1 Year	5 Year
Loomis Sayles Growth Fund (Y Shares)*	1.53 %	19.00 %	5.17 %	6.98 %
Loomis Sayles Growth Fund (A Shares) with MSC**	-4.19 %	11.89 %	3.69 %	6.11 %
Russell 1000 Growth Index	3.09 %	13.14 %	1.66 %	6.50 %

\*Class Y share are only available to certain institutional investors. Please see the prospectus for more details.  
\*\*Reflects maximum sales charge of 5.75% at time of purchase.

\* as of 3/31/06

TOP 10 HOLDINGS	% of Net Assets
Apple Computer, Inc.	3.33 %
Goldman Sachs Group, Inc.	3.28 %
UnitedHealth Group, Inc.	3.26 %
QUALCOMM, Inc.	3.24 %
Legg Mason, Inc.	3.16 %
Lehman Brothers Holdings, Inc.	3.08 %
Cisco Systems, Inc.	3.03 %
Moody's Corp.	2.90 %
Starbucks Corp.	2.87 %
Corning, Inc.	2.66 %

SECTOR ALLOCATION	% of Net Assets
Capital Markets	12.88 %
Healthcare Providers & Services	12.54 %
Communications Equipment	10.36 %
Computers & Peripherals	6.64 %
Specialty Retail	5.62 %
Biotechnology	5.33 %
Diversified Financial Services	4.52 %
Healthcare Equipment & Supplies	4.18 %
Machinery	3.38 %
Hotels, Restaurants & Leisure	2.87 %

Frequent portfolio turnover may result in increased tax liabilities, which will reduce your overall return from the fund.

Growth stocks are generally more sensitive to market movements than other types of stocks because their stock prices are based on future expectations. This fund may invest in foreign securities, which may be affected by currency fluctuations, higher volatility and limited liquidity.

The information is dated as indicated and cannot be relied upon as current thereafter. This portfolio is actively managed and holdings are subject change. There is no guarantee the fund continues to invest in the securities or industries referenced. Reference to specific securities or industries should not be considered recommendations for action by investors. In addition, the opinions expressed are those of the manager and are subject to change at any time without notice based on changing economic or market conditions. Frequent portfolio turnover may result in increased tax liabilities, which will reduce your overall return from the Fund.

*For more complete information about the Loomis Sayles Growth Fund, or any other Loomis Sayles fund, including charges and expenses, please write or call IXIS Asset Management Distributors L.P., for a free prospectus. Investors should consider a fund's objective, risks and expenses carefully before investing. This and other information can be found in the fund's prospectus. Please read the prospectus carefully before you invest or send money. IXIS Asset Management Distributors, L.P. (member NASD), 399 Boylston Street, Boston, MA 02116 Call 1-800-633-3330 or visit [www.loomissayles.com](http://www.loomissayles.com).*



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