CHAPTER 2

Andy Stephens

Lead Portfolio Manager, Artisan Mid-Cap Fund

Andy Stephens has been the Lead Portfolio Manager of the Artisan Mid-Cap Fund since its inception in June 1997. In both 2000 and 2001, the annual Barron's/Value Line Fund Survey ranked Stephens the number one manager in its Growth Fund Category out of 213 managers.

A $10,000 investment in the Artisan Mid-Cap Fund made at its inauguration would have grown to $33,253 by the end of 2003; the same amount invested in the S&P 500 index would have grown to only $13,854.[1] Like many growth funds, Andy's fund performed exceptionally well during the bubble years of 1998 and 1999, generating a 110 percent return during that period and walloping the S&P 500 index by 54 percent and the Russell Mid-Cap Growth index by 32 percent. However, Stephens's careful attention to value helped him continue his exceptional relative performance during the next three bear years, besting the S&P by 31 percent and the Russell index by an astounding 42 percent![2]

Stephens's conservative appearance and calm demeanor are quite deceiving. Inside lies a competitive nature rivaling that of any top professional athlete. That competitive bent compelled Andy to overcome his austere upbringing and become one of the most successful money managers in the country. Relentless in his quest to create an investment process that would allow him to consistently outperform his competition, Stephens has dissected virtually every aspect of investment management to develop his winning style.

PERSONAL BACKGROUND

The Path to Money Management

Andy's unique approach to money management has its roots in his hometown of Wisconsin Rapids, a semirural town in central Wisconsin of about eighteen thousand people. Stephens's mother, a single parent from the time he was eight years old, struggled to support her family of five on the modest salary of a dental hygienist. Being raised in such humble circumstances instilled a respect for money in Andy and inspired him to declare at sixteen, "I will never be poor as an adult!" That pledge greatly influenced each of his career-related decisions, ultimately leading him to become a money manager.

"My resolution never to be poor isn't about being rich," Stephens explains. "It's more about a craving for financial security. I grew up being the kid who could never afford the things I wanted. I had to wear the same clothes two days in a row and was never able to go on school trips. My mom felt very bad about it, but that's the way life was."

No financial planners or money management firms operated in Wisconsin Rapids from whom Andy could learn about investing and wealth accumulation. While most families in Stephens's hometown were lower middle class, a few had achieved financial success. Andy noticed one dominant trait characterized those families that excelled financially—the breadwinners specialized in important areas of need. Becoming experts in their fields created demand for their services and made their time worth more than the average corporate employee's, allowing them to earn higher incomes. The lesson was obvious: if Stephens was to fulfill his vow, he had to become one of the best in a given area of expertise.

Stephens left home to attend the University of Wisconsin–Madison at eighteen. Unknown to Andy, the university offered one of the oldest and best-known applied securities programs in the country. Several top contemporary money managers graduated from this program, including Bill Nygren, manager of the Oakmark and Oakmark Select funds, and Rick Lane, manager of the FMI Focus Fund.

In addition to the applied securities curriculum, the university offered a real estate investment program headed by James Graskamp, a renowned real estate investor. The program, as well as the career opportunities it offered, impressed Stephens, so he opted to seek a Real Estate Finance degree under Graskamp's tutelage. Andy was convinced this was the field he should pursue as a livelihood—until he took a securities analysis class his senior year. That experience transformed his perspective on life and how he wanted to spend his future. Like Saul on the Damascus road, Stephens had discovered his calling.

Strong Corneliuson

Realizing his future lay in money management, Andy aggressively sought a career in that field. After graduation, he accepted a marketing position at Strong Corneliuson Capital Management, a mutual fund complex. "This was not an analyst's job," he says. "But it got my foot in the door at a reputable money management firm."

In time, Stephens transferred to trading and managed that area of the business before long. It was while running that department that Andy got his first big break.

Bill Corneliuson, one of the founders of the company, announced his retirement in late 1993. Corneliuson managed the conservative Strong Investment fund, a "widows-and-orphans" balanced fund that invested in both fixed-income securities and equities. Andrew Ziegler, Strong's president, began an immediate search for Corneliuson's replacement. Having worked with Stephens on several projects, Ziegler knew that Andy had been researching theories of investment management and was developing a securities selection process. Based on that knowledge and his positive experiences with Andy, Ziegler asked Stephens to manage the equity portion of the Investment fund.

Few money managers inherit a $110 million portfolio their first day on the job. Stephens fully understood his good fortune and for the next year and a half used his new position to test his investment theories and develop a successful, repeatable securities selection process.

Andy made his top priority achieving consistent performance in order to maximize the power of compounding for his investors. He also wanted to avoid taking much risk because he lacked experience in fundamental analysis. To accomplish both objectives most reliably, Stephens initially managed the portfolio in what he calls a *passive-active* manner. He employed a passive style of management for the bulk of the portfolio, largely mimicking the S&P 500 index, and used his own stock selections for only a minor portion of the fund.

The rub with this strategy was that Andy's performance largely shadowed the broader market. That may be sufficient for less ambitious money managers, but Stephens's competitive bent made such average returns unacceptable. He aspired to consistently outperform the market and kept asking, "How can I find more of the stocks that go up and fewer of those that go down?"

Dick Weiss's Influence

About that time, Dick Weiss joined the firm, moving over from Stein Roe. Weiss, a stock picker who thoroughly scours companies' financial statements in his search for quality investments, comanaged the Strong Special Fund with Carlene Murphy. Andy developed relationships with both managers and resolved to learn more about fundamental analysis from them. He was still pulling double duty, running the trading desk and managing the equity portion of the Investment fund.

Andy arranged to meet with Dick or Carlene almost every morning for about twenty minutes, showing them analysis he had worked on the night before and asking questions about it. After a year and a half of those meetings, Andy had acquired the analytical expertise he previously lacked and was sharing fresh investment ideas with Dick and Carlene on a regular basis. As his skills improved, Andy gradually increased the actively managed portion of his portfolio, giving greater weight to the securities his research generated.

A Fund of His Own

As time passed, Stephens began feeling constrained at Strong. He had worked hard refining his process and was eager to apply it in a greater way. Andy needed an outlet to express *his* convictions about investing and wanted a portfolio that allowed him to put his theories into practice. “As an artist, you want to paint your own art,” he says. Stephens’s frustration grew as circumstances prevented him from pursuing certain avenues his research indicated would be profitable. He became convinced he could fully develop his ideas only by managing his own fund.

Stephens also realized he needed a team to fully implement his strategy—one person was insufficient. He was missing opportunities in different pockets of the market solely because he lacked the time to pursue them. However, building a team required more resources than were available to him at Strong.

As Stephens considered possible solutions to his dilemma, he thought of his old friend Andrew Ziegler. Andrew, along with Carlene Murphy, had left Strong a couple of years earlier to start Artisan funds, of which he was now president. Andy decided to approach Ziegler with a proposal for a new mutual fund.

A former lawyer with a keen analytical mind, Ziegler understood that long-term success in the investment business required a well-defined process. Since Ziegler knew Stephens and had been impressed with his earlier work, he agreed to let Andy present his investment methodology to him and Carlene. Stephens reflects on that experience: “I’m still not convinced that Andrew really believed I had developed an adequately detailed process. However, a point-by-point three-hour presentation sold him.” Ziegler offered Andy his own fund and committed the resources necessary to build a team.

STEPHENS’S INVESTMENT PROCESS

Andy confides that his desire for financial security influenced not only his decision to pursue a career in money management but also how he views risk and manages investments. Realizing the irony that you must take risks to achieve financial security, Stephens developed a style of money management he brands *daring prudence*. “You have to take some offensive moves,” he says. “But at the same time you can’t just leave your risk unlimited. I’m talking very calculated risk taking.”

That fundamental belief clearly plays through in his investment strategy. “My process is all about handicapping risk,” Andy states emphatically. “I evaluate the probability of failure and the potential payoff of any given situation. If I can get a handle on these things, then I can understand the risk I am taking to be involved and determine if the likely payoff justifies my investment.” Andy first applies this concept to the selection of individual securities. Then he builds a mosaic of different risk levels and expected returns into a portfolio that protects investors on an overall basis.

KEY POINT

A performance benchmark serves as the foundation of Stephens’s process—a process focused on generating consistent investment results. “I strive to perform at an above average level relative to the competition most of the time, and when I miss that mark, I try not to fall below the median. Then I can achieve the compounding offered by the capital markets and offer my clients superb performance.”

Batting Average and Slugging Percentage

Andy divides his investment process into two parts: (1) security selection, which he talks about in terms of his batting average, and (2) portfolio management, which he thinks of as his slugging percentage. His batting average refers to the percentage of stocks he selects that are ultimately profitable, while his slugging percentage relates to the percentage of the fund’s assets that gets invested in his best ideas. Since, like most money managers, Andy takes bigger positions in some securities than others, a high batting average does not necessarily translate into a high slugging percentage. For instance, if he invested the majority of the fund’s cash in a minority of losing stocks, he would generate an inferior return. He must place the majority of the portfolio's funds in his most profitable stocks to beat the averages.

Andy understands that not every stock he buys will be a winner. As much as he respects Warren Buffett, this is one area where he disagrees with the Oracle of Omaha. Buffett has stated that on graduating from college every person should be given a punch card that permits them to make twenty investments during their lifetime. Their card gets punched each time they buy a stock, and they can make no more investments after twenty punches. Buffett makes the point that investors would research companies much more thoroughly before placing money in them if they were allowed to make only a few investments during their lives.

While Stephens understands the sentiment behind Buffett's statement, he also realizes that investors will make mistakes—indeed *must* make mistakes—to learn what investing is all about. "It may take two thousand punches before someone can boil everything down to what they really believe," Andy says. "It's a game of mistakes. It's how you control those mistakes and learn from them that is important."

A good batting average helps Stephens minimize losses and adds consistency to his investment results. It is, in a sense, the defensive side of money management. However, defense does not win games; it only prevents losing. Big offense wins games, which is why Stephens requires a healthy slugging percentage to beat the averages over time.

KEY POINT

"The art of portfolio management, at least the way I do it, is to be right more than I am wrong—at least to be right in a bigger way," Andy explains. "It's a trade-off between capitalizing on opportunities and protecting my downside if I make a mistake."

The Security Selection Process

Andy believes the stream of cash flow a business generates is what you ultimately acquire when you buy its stock. You capitalize that income—that is, place a current (net present) value on it—when valuing the corporation (see Chapter 10 for a detailed explanation of this concept). Other factors, such as the industry in which the firm competes and the country in which it operates, are generally unimportant except to the extent that they impact the company's cash flow. Not only is the level of the firm's earnings significant when valuing a business but the reliability of those earnings also matters. To maximize the reliability of a company's cash flow, a barrier must be in place to protect it from eroding due to competition.

Structural Competitive Advantages

Competition is a powerful force that makes it difficult for firms to earn above average returns for their shareholders. If a corporation generates excessive profits from engaging in a particular activity, whether it be producing a good or offering a service, the excess returns available will soon attract other businesses to that activity. The additional competition will then reduce the level of obtainable profits. Therefore, to secure a *protected* stream of cash flow, you must acquire a firm that possesses a *structural competitive advantage*. Money managers often describe such an advantage as a moat around a company that prevents other enterprises from entering its business and competing effectively with it. Andy looks for four types of structural advantages:

1. Dominant market share
2. Proprietary asset
3. Lowest cost structure
4. Defensible brand

Dominant Market Share. Dominant means that when a firm makes a pricing or volume decision, the industry imitates it—that is, it drives industry actions instead of mimicking the leadership of others. For example, when AOL raised its monthly subscription fee from $19.95 to $21.95, virtually the entire Internet service provider (ISP) industry followed suit.

Proprietary Asset. Most money managers define a proprietary asset as a patent or a technology that no one else possesses. Andy characterizes it in broader terms as something unique that a firm can leverage. It can be as simple as location—a retail shop resides on the corner of Main Street and Market Avenue, making the business visible to the heaviest traffic flow in town. Or for some financial services companies, this asset may be a twenty thousand–member sales force, the business equivalent of a huge army that would be almost impossible for a competitor to replicate.

Lowest Cost Structure. This advantage especially benefits firms in cyclical industries at the low points of their business cycles. When all the companies in an industry are suffering, the low-cost producer often bankrupts it competitors or buys them out. Maintaining the lowest cost structure often correlates with possessing a proprietary asset. For example, a business might produce at a lower cost than its competition if it owns the only processing facility next to a particular coal mine.

Defensible Brand. This structural advantage requires constant care and feeding, probably making it the most difficult to achieve and maintain. A business must continually spend on its brand to preserve its worth. The world is littered with leveraged buyouts where companies bought brands and then underspent on them, eroding their values and the competitive advantages for which the acquiring firms paid so dearly.

Andy looks for at least two of these four qualities in every company he buys. Finding suitable investments that possess all four characteristics is very unusual because such businesses are normally monopolies that operate in regulated industries. However, firms that possess two or more of these advantages will likely perform in the upper quartiles of their industries. Because their cash flow is safeguarded, investors can value these firms with a higher level of confidence.

The first step, therefore, in the security selection process is to find qualified companies—those earning above average returns with structural competitive advantages that protect their cash flows.

Valuing a Stream of Cash Flow

After finding a company that meets his criteria, Andy calculates an appropriate value for its projected stream of income. "Statistically, there is a correct price to pay for a company based on the amount of cash I expect it to generate," Andy says. "The factors involved in determining this price are the level and reliability of the company's cash flow and how rapidly I believe that cash flow will grow."

When investors capitalize a stream of income, they determine a present value for it by calculating what they would be willing to pay to own it. Owning a stream of income typically gives a person the right to control it. In the public capital markets, however, investors do not control a firm's cash flow. Company management, not the shareholders, decides how to allocate profits. Therefore, "I compensate for that lack of control by seeking to buy firms at discounts to their private market values," Stephens remarks. "In fact, I strive to pay no more than 60 percent of what a business is worth."

Andy advises investors to buy companies in a "window of cheapness." An investor gets a real bargain when acquiring a quality corporation at 60 percent of its private market value. If its price drops significantly below that, however, a private buyer will likely be able to finance the purchase of the corporation profitably, making it highly unlikely a business will become *too* cheap.

Andy sells a company once its price reaches its private market value, believing he is playing the "greater fool" game if he hangs on beyond that point. Investors may get lucky on occasion and profit by holding the stock longer, but that strategy generally increases the inconsistency of their returns without a commensurate reward.

Capitalizing on a Firm's Future Growth

Up to this point, everything in Andy's process has involved objective analysis—the *prudence* parts of his approach. First, make as certain as possible that a company possesses a reliable stream of recurring cash flow. Second, be sure you understand how to value its cash flow so that you do not overpay for the business. Now he introduces a subjective element to the process that affords investors who do their homework a possible advantage over other investors. In this third element of security selection, the *daring* part of his strategy, Andy attempts to capitalize on the growth potential of a company.

You must first understand the concept of profit cycles to grasp how this third area of security selection works. Andy has observed that most firms do not grow in a linear fashion—they do not increase revenues and earnings by the same percent every quarter. Rather, companies experience periods when profits advance at well above average rates followed by periods in which their earnings consolidate. Those cycles repeat over time.

Key Point

"Regarding business cycles, what I have come to understand is that when things go well for a company, they can't help but get better, and when things go bad, they can't help but get worse," Andy says. This belief is fundamental to Stephens's investment philosophy.

The power behind profit cycles lies in the notion of *incremental margin*. A high percentage of a company's operating costs is typically fixed, so any acceleration in the firm's revenues expands its margins and causes its net profits to grow disproportionately. An effective management team then reinvests some or all of the excess cash into perpetuating the company's sales growth, creating a positive profit cycle. To maximize a cycle's benefits and seize additional market share, an enterprise will pour money into such activities as hiring more sales professionals, increasing R&D expenditures, and beefing up advertising, all in an attempt to reach a higher profit level faster. The same process also works in reverse. When sales decelerate, margins wane and profits shrink disproportionately.

Andy endeavors to find businesses that are about to embark on positive profit cycles. Because the most powerful gains typically occur early on, you will often miss much of a stock's excess return if you buy it after the profit cycle has started. Stephens explains, "I want to buy a company when I have quality (structural competitive advantage) and value (price discounted to its private market value) on my side to protect me from downside risk, and a positive profit cycle lies in front of me. This gives me the ideal combination of limited downside with huge upside potential."

So try to buy a company a little early—just prior to the start of its profit cycle, giving you time to understand the business well enough to recognize when the positive cycle takes hold. If you buy a little early, your investment may tread water for a while after you purchase it. Be patient. As its cycle unfolds, you can increase your position in the stock.

Catalysts for Positive Profit Cycles

Positive profit cycles generally require a catalyst—a change of some sort that jump-starts them. Andy divides these changes into two categories: external and internal. External changes are secular events that cut across entire industries, whereas internal changes are company specific. Money managers commonly invest in change. However, Andy believes the change itself is not as important as the breakthrough that produced it.

Regarding external changes, Stephens looks for breakthroughs in two main areas: new technologies and regulatory events. For example, the shifting of our information infrastructure from an analog mode to a digital mode created tremendous excitement in the technology sector during the late 1990s. On the regulatory front, we witnessed the repeal of the Glass-Steagal Act and the passing of the Telecom Act in recent years. New technologies and regulatory events of those magnitudes drive tremendous changes that often create enormous investment opportunities.

Andy also looks for company-specific changes, such as a new management team, a big acquisition or divestiture, a major restructuring, or a new product launch. A positive internal change can turn an ailing company's fortunes and propel it forward, unlocking its inherent value. "My biggest gains have come from companies experiencing both types of changes," Andy explains. "External changes created secular tailwinds blowing through industries, and internal changes further amplified firms' performances. My biggest advantage in analyzing these businesses is that few people know how to predict the benefits of these changes. Everyone was taught in business school to calculate their impacts in a linear fashion."

The Risk of Companies Failing to Meet Your Expectations

Stephens considers the risks of companies falling short of the results he expects. "In valuing a firm, I think about the discount rate as the odds against an outcome," Andy says. "Just like in Vegas you handicap your odds, you must do the same in investing. The higher the risk of a business failing to meet your earnings expectations, the bigger the discount factor you apply to its projected cash flows to arrive at its private market value."

Uncovering Unexpected Growth

Stephens seeks to gain a competitive advantage by uncovering future growth potential in corporations that other money managers and analysts miss, so consistently growing enterprises do not interest him unless one of two conditions exists. First, a lack of consensus, or a shrinking consensus, regarding a firm's prospects can create opportunity. In this situation, the market misprices a company because investors underestimate the firm's growth potential, failing to recognize it is embarking on a new profit cycle. For instance, the market values a business based on 15 percent annual growth when in fact it is becoming a 20 percent grower. When this happens, investors often do not realize the extent of a change the company has experienced—a mistake on which Andy can capitalize.

The second condition occurs when a firm continues to grow earnings in line with historical trends, but investors discount its price because they fear a negative outcome to some issue on which the market lacks complete information. For example, a company is the subject of a lawsuit and investors differ in their opinions about the likely outcome. Another situation would be a lack of clarity on the extent of a recently discovered accounting irregularity. In recent years, because of the fear engendered by numerous scandals, quality companies that even hinted they may have accounted for revenues or expenses improperly were often punished well beyond any possible extent of their errors. Investors shot first and asked questions later, often resulting in undeservedly low prices.

Andy believes the market generally prices stocks efficiently except when investors differ markedly in their expectations for a firm's growth. If the projected earnings growth for a company is well defined, the stock price should accurately reflect those expectations. However, investors often price a stock based on a low-probability worst-case scenario when a lack of consensus is present.

YOU SHOULD IMPROVE YOUR BATTING AVERAGE AND UNCOVER SEVERAL winning situations by applying Andy's principles of security selection to your stock analysis. However, several questions remain: Should you buy the same amount of each investment in your portfolio, or should you weight them in some fashion? When should you sell a stock? How many stocks should you own? These and other questions lead us to Andy's philosophy on designing a portfolio.

CONSTRUCTING A WINNING PORTFOLIO

Having discovered some excellent candidates for investment, we must now combine these companies into a winning portfolio, leading us to Andy's capital allocation process. In other words, how do you get more money into the best-performing stocks and less into the ones that don't pan out as you expected?

Andy moves from baseball to farming to explain how he allocates money among his stock picks. He divides his portfolio into three categories: the garden, the crop, and the harvest (remember Chauncey Gardener?). "Everyone pokes fun at me for this analogy," he says. "But it's really the way I think about it." The object of this strategy is to limit the damage from being wrong about a company and to magnify the upside when you are right. Investing is a risk business, and how you manage that risk greatly influences your ultimate performance.

The Garden

In this segment of the portfolio, Andy takes risks on stocks that he believes meet his criteria but have not yet entered their profit cycles. It typically comprises between 20 and 40 percent of his fund. These companies carry a higher risk level because they have not yet proven their ability to fulfill their growth potential. Since he is not totally persuaded about these firms' prospects, he limits the size of each of these positions to about 1 percent of the portfolio.

Why would he invest in a corporation before he is convinced it will meet his growth expectations? First, Andy believes that unless he owns a company and puts some capital at risk with it, he cannot expend the effort necessary to analyze it thoroughly and develop confidence in his idea. Buying a firm and placing it in the garden commits him to following it. Second, in the public markets there is a trade-off between time to market and perfect knowledge. He will likely miss out on substantial appreciation in a stock's price if he waits to invest until the firm's positive earnings outlook is clear.

If a business begins to expand its earnings as he expects, he increases his allocation to it and moves it into his crop.

The Crop

In the crop, Andy takes big positions in companies that have entered their profit cycles and convinced him that they will meet his growth expectations. He generally makes the bulk of his profits from this part of the portfolio. However, he maintains he cannot produce a crop without a garden.

Stephens believes in the 80/20 rule, which states that 80 percent of most portfolio managers' returns come from 20 percent of their investments. His challenge is to place the majority of the portfolio's assets into the few companies that will generate the highest rewards. This approach means taking bigger positions in a smaller number of names.

The crop, therefore, typically comprises between 60 and 70 percent of the portfolio and consists of ten to twenty names. Andy generally invests 2 to 5 percent of the fund in each of these stocks, convinced he knows virtually everything there is to know about them. "I perform best," he explains, "when my top ten positions represent over 30 percent of the portfolio."

Even though the crop is more concentrated than the garden, he still diversifies this portion of his fund. Often, when one company experiences a profit cycle, other businesses in the same sector do likewise. Thus, Andy may own several similar firms in the crop at the same time. However, he avoids overconcentrating in any one sector of the market.

Andy varies the sizes of the crop and the garden based on how many companies he finds experiencing positive profit cycles. For example, gross domestic product (GDP) growth was decelerating sharply during the middle of 2001. Profit cycles were sparse, so the crop represented only 25 percent of his portfolio, while the garden comprised half of it. This allocation resulted in lots of 1 percent positions while Andy waited for the economy to rebound and generate more profit cycles. "In general, businesses rely on the overall level of economic activity. They're simply multiples of the total economy," he says. The crop constitutes a higher percentage of the portfolio when the economy spawns a greater number of profit cycles.

The Harvest

Andy uses the harvest to pocket gains and reduce, or eliminate, positions. He believes you should reduce your investment in a company for two main reasons: reaching your price target and decelerating earnings growth. The best reason to sell a stock is based on its price, largely because this basis removes emotion and subjectivity from the decision-making process. You establish a price you believe represents full value for the firm, the stock reaches that price, and you sell it. Simple enough, right? It is as long as you don't make the mother of all mistakes in this area—getting greedy! Too often investors try to squeeze every penny of profit from a stock and continue holding it after its price has reached full value, only to watch their hard-earned profits evaporate!

The full-value price for a company's stock is a moving target. As the firm's profit cycle begins and its earnings increase, its value grows as well. However, as its profit cycle accelerates, you cannot keep applying a faster growth rate to higher earnings numbers to determine its value. Otherwise, you eventually compound to a figure that is way above its actual private market value. (Author's note: Technology investors made this devastating mistake in the late 1990s, resulting in the infamous bubble.) Rather, you *normalize* the firm's growth rate to an average level that you believe it can sustain over the entire cycle and hold that figure constant. Credit the company for higher profit numbers as it reports them, but keep the growth rate static in your calculations.

Andy values a stock very conservatively at first, starting with a number based on his mid- to worst-case scenario. "I don't want to pay for the pro forma [the excess growth he projects above the consensus estimate of the market]," he says, "even if I think something good is going to happen. You should not have to pay for that. That is what you should get for assuming the risk of owning the stock."

As the corporation reports earnings each quarter and its profit cycle develops, he adjusts his calculations to reflect the higher income figures and boosts his valuation range. The company's price will likely ascend through the top of that range if its earnings move through the "hockey stick" as he expects. Selling the stock at that level leaves a little room for others to make money from purchasing it. Otherwise, no one will buy it from him. "It's hard for me to believe I will be able to sell $200 million to $300 million of a stock right at the top," Andy declares. "The purchaser must be able to make some money, or he will not buy it. However, in my mind it is overvalued at that point."

You should also sell a stock because the profit cycle for which you bought it decelerates. Remember a pillar of Andy's philosophy: "When things go well for a company, they can't help but get better, and when things go bad, they can't help but get worse." As a firm's earnings growth slows, the company's prospects will likely deteriorate more than most investors anticipate, so you should lock in your profits and reduce or eliminate your position at that point.

What about market timing? Does Andy increase his cash level in a slowing economy, when there are few positive profit cycles, as a defensive measure? While he finds it very seductive to think he can predict market trends, Stephens resists the temptation to time the market, convinced this is a mistake that ultimately costs investors. Studies show that about ten key days of trading during profit cycles materially impact the returns that investors capture. Experience has taught Andy that the market has a way of doing what nobody expects, and his timing could easily be off. Missing just a couple of those big days could significantly reduce his return and place his clients at a disadvantage—a risk he is not willing to take. Rather, he assumes shareholders want to be exposed to equities by investing in his fund.

GENERAL PORTFOLIO MANAGEMENT PRINCIPLES

Although Andy does not time the market, he does take one important step to lower the risk of investing in equities during an economic downturn. When a scarcity of positive profit cycles exists, he enlarges his garden and shrinks his crop—that is, he increases the number of stocks with small positions in his portfolio and reduces the number of his bigger bets. Statistically, that dampens his risk, since the damage from a losing garden stock is less than that of a bad crop investment. Stephens believes it is foolhardy to maintain concentrated positions in companies that are not experiencing positive profit cycles. Once earnings cycles develop, he winnows the garden and allocates more money to his top ideas.

KEY POINT

Andy's research suggests he maximizes his return during a normal profit cycle by holding forty-five to fifty names in the portfolio, with the crop constituting between 60 and 70 percent of the fund. This leaves him with several large (4 to 5 percent) positions that typically produce most of his gains.

When they see forty-five to fifty names in his portfolio, some investors wonder if such a diversified fund lacks the punching power of a more concentrated portfolio. Don't be fooled. Remember that Stephens invests most of the assets in only fifteen to twenty companies, giving his fund the potential to outperform its benchmark indices without focusing on especially high-risk businesses.

CREATING VALUE

How does Andy's strategy differ from that of traditional value investors? Andy tries to acquire a growing dollar instead of purchasing a static dollar for fifty cents and waiting for someone to buy it from him for seventy-five or eighty cents. He seeks companies that will create enormous *future* value by their actions—that is, he endeavors to pay a reasonable price for a current dollar that he hopes will grow to five dollars in a few years. He just doesn't want to pay for all that expected growth up front.

Since typical value managers do not take the same risk as Stephens in terms of banking on businesses creating future value, they can afford to take a rifle approach and concentrate their portfolios. Andy invests in growth companies that by their very nature carry a substantially higher failure rate—not failure as in going out of business but as in not meeting their profit cycle growth potential. He reduces the impact of this risk by taking only small positions in firms until he is confident they will meet his growth expectations.

As Andy explains it, "I *am* a value investor of sorts. But I don't determine what a company is worth today and buy it at a discount to that figure. Rather, I project what its actions will make it worth in three to five years and discount that number back to today to determine its current value. Ideally, I want to buy the business at about 40 percent below that amount. However, the firm must deliver on my growth expectations for my calculations to be correct. That's the extra risk I take for which I want to be rewarded."

A traditional value investor can justify buying stock in a corporation that fails to increase its earnings dramatically because she only pays fifty cents up front for a dollar's worth of value. To the contrary, Stephens *requires* that a company grows its earnings to justify his purchase price. However, he hedges his bet by paying only sixty cents on the dollar for that expected growth. Stephens also increases the conservatism of his calculations by making sure he uses a prudent growth rate in his fair value computations. He arrives at that growth figure by starting with his best-case growth scenario and then backing it down to what he believes the firm can reasonably be expected to achieve under less than ideal circumstances.

WESTERN WIRELESS: A CASE ANALYSIS

Andy's initial analysis of Western Wireless typifies how he implements his strategy. "A traditional value investor would have appraised the company's assets and the worth of the licenses it had acquired to determine its present value. They would then have bought shares of the company only when it was selling for a large discount, maybe 50 percent, to that figure."

Andy viewed the situation differently. First, he considered the fact that Western Wireless had obtained licenses to function as one of only two wireless operators in numerous rural areas across the country, making them, in essence, a licensed duopoly.

Next, he estimated the potential customer base for Western's service. The number of users hinged on the penetration levels eventually reached in the areas where Western operated. In Europe, where they were about three to four years ahead of the United States in wireless operations, penetration rates for this type of service normally climbed quickly to about 50 percent once they passed the 20 percent threshold. Stephens saw no reason to assume results here would differ significantly. Since the United States was experiencing only 3 percent penetration at the time, Andy concluded that figure would mushroom over the next few years.

Western was in the process of building its wireless network, which required a huge initial capital investment. Once it completed this project, however, ongoing capital expenditures should be minimal, transforming the operation into a cash cow. When that occurred, what size margins would Western likely achieve? European wireless firms generated EBITDA (earnings before interest, taxes, depreciation, and amortization) margins averaging between 30 and 40 percent. Domestic cable companies operated at about 45 percent margins. Western's business was not so different from cable as to make its margin potential incomparable. Andy postulated Western could reasonably be expected to achieve 40 percent EBITDA margins.

Armed with that information, Stephens needed only a little detective work and simple mathematics to answer the following four questions and estimate Western's future cash flows: How many people reside in its areas of distribution? How many of those residents will likely become subscribers? What will each subscriber pay per month for wireless service? What margins will the company achieve in three years? Andy calculated Western's worth three years in the future using the resulting cash flow projections, and then discounted that figure back to the present to determine a fair market value for the firm. Those computations convinced Stephens that Western's price was discounted sufficiently to its value to justify investing in the company.

SUMMARY

The following summarizes the main points of Stephens's investment philosophy:

Security Selection

- Acquire companies with reliable cash flows. Look for firms that possess structural competitive advantages capable of protecting those cash flows from competition. A structural competitive advantage can be a dominant market share, a proprietary asset, low-cost producer status, or a defensible brand.
- Calculate the present value of a corporation's future cash flows to determine its fair market value. Try to buy the business at a sizable (ideally at least 40 percent) discount to its value.
- Buy companies just prior to the start of their profit cycles, looking for firms that are experiencing internal and/or external changes. Internal changes include such things as a new management team,

a big acquisition or divestiture, a major restructuring, or a new product launch. External changes include new technologies and regulatory events.

Portfolio Allocation

- Maintain a garden—a portion of the portfolio that includes small positions in stocks that meet your requirements but have not yet entered their profit cycles.
- Increase your positions in companies as they begin their profit cycles and move them to your crop—that part of the portfolio where you take bigger positions in firms that have proven their abilities to meet your growth expectations.
- When a stock reaches your target price or its profit cycle begins to decelerate, reduce or eliminate your position in it—harvest it.
- Do not time the market; always remain fully invested.
- Reduce the size of your crop and increase the size of your garden to lower your risk during economic downturns when profit cycles are sparse.
- Do not overconcentrate in a single sector of the market.