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INVESTING Q&A

Scoring with a Few Good Stocks

Companies with low volatility and high predictability are what London Co.'s Stephen Goddard focuses on for his New Market Fund

The stock market may be bobbing and weaving, but a bit of a down market doesn't bother Stephen M. Goddard, president of London Co. and manager of its New Market Fund ([AVMIX](#)). His fund has been modestly outperforming the market, thanks, he says, to its focus on a few good stocks -- no more than 25 at a time -- with low volatility.

One of the fund's success stories was Gillette, which it acquired in 1999 when it was a black sheep because of disappointing earnings. Goddard says he saw long-term value five years or more out, and that vision was confirmed early this year when Gillette was acquired by Procter & Gamble ([PG](#)). That gave the fund a substantial position in P&G. Interestingly, Goddard is unsure whether to retain that big a share. It depends on how P&G takes advantage of the purchase, which was made at 15 times earnings.

Goddard's criteria for buying a company are the quality of management, cash flow, and valuation. Among the stocks he cites as current favorites are Berkshire Hathaway ([BRK.A](#)), Capital One Financial ([COF](#)), and MBIA ([MBI](#)).

These were a few of the points Goddard made in an investing chat presented Mar. 24 by BusinessWeek Online on America Online, in response to questions from the audience and from [Jack Dierdorff](#) and [June Kim](#) of BW Online. Following are edited excerpts from the chat. AOL subscribers can find a full transcript at keyword: BW Talk.

Q: Steve, how do you see the outlook for this market, as it bobs and weaves?

A: I think it's going to continue to bob and weave -- we have valuations that are fairly full, and a rising-rate environment that will continue to crimp valuations.

Q: How has the New Market Fund been doing in this uncertain market?

A: We've been outperforming the market by a modest amount, mainly because we're holding more low-volatility, predictable franchises. The valuations are at a discount to the rest of the market overall. We do very well in a modest down market and hold our own in an up market, and that's because we tend to focus more on the downside than on the upside.

Q: During this rising-rate environment, where do you see value? Can you cite any specific companies?

A: We have several companies in our universe that have come down to fairly attractive levels. Berkshire Hathaway continues to be fairly attractively priced compared to its value. So do Capital One Financial and MBIA, trading at 15 times earnings. Capital One is at 10 times earnings, but growing at a mid-double-digit pace, 15% on average.

Q: Are you still heavy in financials? Isn't that a concern with margins tightening?

A: Well, that's why they're down in the first place. That particular news is already discounted in the valuation -- it has been no secret that the margins are tightening. Most of the financials we own don't rely so much on spread income. Our major holdings are more property/casualty insurance companies, which can hold their own better in a rising-rate environment. Berkshire Hathaway is sitting on a tremendous amount of cash, and even a small increase in rates can add to their holdings in a meaningful way.

Q: Your fund's strategy is to concentrate holdings -- how many stocks are typically in the portfolio?

A: We try to hold at less than 25 positions. Once you get beyond 25, you basically become a closet indexer, and it's very difficult to add value when you have that many positions. The average fund holds about 85 different positions, and basically you're just holding the market. That's fine when the market is going up 18% a year, but if we get into a market that's very subdued, with low-

single-digit returns, a mutual-fund manager's not going to have the luxury of owning the market.

Holding 10 to 15 blue-chip companies is all you really need long-term to generate good returns and keep your risk down...we're ranked in the top 5% of large-cap funds since conception. Our beta is also lower than funds that own three times the stocks we do. It kind of defies the conventional wisdom that the more you own, the lower your risk is.

Q: What kind of risk level does your fund carry?

A: The lowest that Morningstar gives you. Our standard deviation is probably two-thirds of the market's, and our beta is 0.55, which is nearly half the market. So we're a very steady, consistent fund that does very well in both up and down markets, but particularly down markets.

Q: With your high degree of selectivity, how does your screening process work in picking the few good stocks?

A: Basically, our screening process has three legs. We look for companies that generate ample free cash flow, and that cash flow is very predictable long-term. We're not going to be looking at commodities or companies that have a great deal of volatility to them. We want to own companies that we know will still be around 5 to 10 years from now.

The second part is looking at the management team, making sure they're shareholder-oriented and have a long demonstrated record of doing what's best for shareholders. If you have one, and not the other, it can end up being a disaster for you.

Finally, the most difficult part is trying to find those companies at a reasonable valuation. We try to use a very modest forecast for the cash flow for that company 10 to 15 years out -- sometimes the growth rate is a fourth to a third of what analysts are projecting. Then we try to figure out what the cost of capital is for that company.

Most companies today are way overcapitalized, utilizing too much high-cost equity to grow when in reality they only need a half to a third of this equity to grow going forward. So what you're going to find going forward is LBO [leveraged buyout] players coming into the marketplace, and you'll see further consolidation of companies, because they can issue very low-cost debt to buy them. You also will see rapidly increasing dividend payouts, because they have too much cash to work with.

I'm not speculating -- you've already seen that happen. Last year a record number of companies increased dividends -- they have more cash than they've had in the last 40 years.

Gillette was just acquired by Procter & Gamble, and you'll see many more consolidate in nearly every industry going forward. I think the main theme -- to make any sort of returns going forward, you're going to have to concentrate on a few good names, find companies that have good free cash-flow characteristics, and play the theme of consolidation and dividend increases.

Q: What's your average turnover on stocks?

A: Our turnover is very low -- we typically don't turn over more than 10% a year, and our holding period is about five years. This makes it a very tax-efficient fund. We don't believe in buying and selling companies based on next quarter's earnings. Our outlook and horizon are well beyond the average Street outlook, looking 5 to 10 years out. When we buy a stock, we're looking at it from the same point a businessman would, and unless there are any major surprises, we're going to hold it for a long period of time.

A perfect example of that is Gillette, which we acquired back in 1999 when everybody hated the company. The market was focused on their disappointing quarterly earnings, and it stayed down in the mid-to-high 20s for a long time. We were looking 3, 5, 10 years out, though, knowing the company was worth more than what the stock was trading at. Our payday came in January [with the P&G deal].

That's the perfect example of the kind of company we're looking for. High operating margins generate large amounts of cash, very predictable. You know it's going to be the same company five years from now as it is currently. Then we just sit back and wait.

Q: With the Gillette deal done, are you happy to have Procter & Gamble?

A: We're still struggling on whether to keep a major position. I thought they paid a full price for Gillette, for nearly 15 times. If they can recognize the synergy they think they can and can cross-sell their products, the acquisition will work. But if they don't, then it's going to be very difficult for Procter & Gamble to meet what the Street expects going forward.

I guess what I'm trying to say is that the jury's still out -- I haven't made a decision one way or the other. Most large acquisitions don't work -- around 75% of them don't, as far as providing returns to the shareholder.

Q: Since you are so picky about buying, do you nevertheless sometimes have to sell?

A: Sometimes we make mistakes, and something might surprise us that we didn't anticipate. Of course, if we find a better idea and need some cash to buy into the new position, we sell. Or if valuations simply get too rich, we reduce our position. Normally,

our companies don't change very much, and we try to keep turnover at a minimum, therefore enhancing the aftertax returns to our fund holders.

Q: What have some of your best success stories been among your stock picks?

A: Most recently it has been Gillette, which was acquired [by P&G] a month and a half ago. White Mountains Insurance ([WTM](#)) we acquired back when it was around \$100 a share, so that has been a fairly good run. I can go back to many positions. Berkshire Hathaway we've owned forever, and that's 10 times what some of our original holder account's costs basis is.

So this justifies that you don't have to move around a lot to make money for yourself. Just find strong companies with strong fundamentals run by a strong shareholder team, and make sure you don't overpay for it. Most successful investors over time don't have the mentality of trading every day or every week. If you look at most of the top-performing mutual funds, almost all of them have relatively low turnover.

Q: With investors keen on dividends these days, do they carry any weight in your selection process, or your returns?

A: Well, our primary screening is free cash, and we hope that translates into dividends over time. Normally we're buying companies that could pay a dividend in the 5% to 6% range if they paid out their free cash. So indirectly we're looking at dividend payers.

It takes a long time to change the mindset of the last 20 years, where dividends were considered almost a sign of weakness, and you had this mindset of CEOs who had a heavy incentive to retain cash to increase their option values. That's coming to an end -- we're entering a new era where the exact opposite will be the case. Instead of getting huge options packages, you're seeing more restricted stock to CEOs. With restricted stock, they get dividends, where with options they don't.

We believe the market is going to go back to the way it used to be prior to the '90s and late '80s, where the majority of returns are going to come from dividends. It will be almost like a surrogate bond market, where the dividend yields of companies will be competitive with what you could get in the bond market.

Edited by Jack Dierdorff

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