

Star Gazer Ed Mathias – Managing Director at The Carlyle Group

Ed is currently a managing director at The Carlyle Group, where he has been a general partner since 1993. He has experienced finance at all levels, including Senior Portfolio Manager of New Horizons Fund at T. Rowe Price, where he also served on their board of directors, and involvement with the formation of New Enterprise Associates.

[start box] “I would start off that you have to have some perspective about the evolution of growth stock investing. A number of people claim creation, but it really was people like T. Rowe Price and David Babson and others in the mid-30’s. In retrospect, the insight they had was equivalent to shooting fish in a barrel, because at the time stocks were yielding more than bonds and growth stocks had a slightly lesser yield, but they had just excellent prospects, so you were able to buy them at a good value. We were also at a time with the size of the economy and the prospects for long-term growth, that the companies had a very long runway, and the original growth stock investors bought great companies basically at a discount to the market.

Growth investing got growing recognition. It peaked in the ’72 two-tier market where the market was going down and the “nifty fifty” were going up. That was the second transition point for growth investing because it then had become extremely popular. Companies sold at very substantial premiums and the criteria that had made it successful in effect had planted the seeds of its destruction.

The second item I would talk about is sort of the magic of compounding, and if you can get long-term growth at a high rate you can pay almost any price. The amazing thing is “many are called, few are chosen.” The mortality rate for companies with a high growth rate is very, very high. It’s striking to see how few small companies ever do become large, though some do, certainly. To some extent, the Microsofts are the exceptions to the rule.

Most companies have a very difficult time sustaining growth for more than a five to seven year period - the numbers fall off quite dramatically. A company that can compound 15 to 17 percent is an extremely attractive long-term investment, if it can be persistent.

What I look for in a growth company can be put in terms of criteria I think this has evolved into several pockets. The first being the long-term trends - people trying to identify an attractive area, whether it be cable TV, semi-conductors, whatever, and buying into that-**EMPHASIZE** market. One thing that we see is within industry groups the market is fairly efficient at ranking the companies and pricing them accordingly. But there are a number of investors who buy into what I call long-term trends. On the other hand, the way to look at it in terms of company fundamentals – you’re putting together a portfolio of very specific company, each of which has particular characteristics, may or may not be economically sensitive, may or may not be in a growth area, but they have a distinguishing characteristic, that suggests that they have superior growth prospects.

Over time, probably the most important factor is the management of the company. I’d say that coupled with a good wind at your back, whether it be from the economy or your industry. Management is extremely hard to assess, and you almost have to go by the history. One of the things that has struck me is when successful managers take over companies, in many cases that’s a very good signal to be a buyer.

You’ve seen companies like McDonalds, Starbucks, Intel, who are continually redefining their company and creating additional avenues for growth and protecting themselves competitively.

The fourth item I would talk about today is the state of growth stock investing. People have tended to cluster stocks in terms of value and growth and look at the relative performance of which we are coming through a period where growth, per say, has under-performed value. There is a saying among the value managers that growth companies eventually become value companies.

From that experience – if you were looking to say, okay, what’s attractive looking out over the next 15 to 20 years, and you were looking for where you could have the highest returns, do you think it’s in the venture capital area, the private equity area, the small cap area... you can’t lump them all into a bucket.

Early stage venture capital is **eternal - EMPHASIZE** and that is going to produce extraordinary returns, and it’s true growth investing to the companies who can create and grow companies, or the venture capitalists can create and grow companies. The data is overwhelming that a few top tier firms see the

best deals and create the most successful companies, and that's just characteristic of the industry. People are starting to figure it out.

I think for relatively modest sums of money and people who are willing to run relatively concentrated portfolios, the small cap area is a very attractive place. I mean there are a number of factors today that are contributing to that, whether it be the lack of research covering, some of the Spitzer effect, the lack of training, lack of liquidity, all of that is creating a market where the opportunities abound.

The average investor probably has to wait until companies become a little more visible and the awareness grows. Having said that, it's much easier to compound from a small base than it is from a larger, that's just the simple rules of arithmetic. And at the end of the day, compounding earnings is the key to growth stock investing. There's an old saying that investment counselors diversify wealthy widows. And to some extent I think that's the case. You don't build wealth by running the diversified portfolio and the idea of letting a portfolio of stocks weigh themselves in the portfolio, and then selling your losers, rather than the winners is a very efficacious strategy, but one that is very, very hard to effectively employ.

Hedge funds are a misnomer because it's really a conglomeration of lots and lots of different strategies. Having so many people at the margin looking for inefficient markets and inefficiencies is likely, at a minimum, to lower returns. I think secondly, hedge funds, because of their economic structure and their time horizons, are not ideally geared to compounding earnings and letting that be reflected in stock prices, which is the essence of growth investing.

The other thing, I would say, is that over time, and given the volatility of the market, even great companies have relatively wide swings in price, and the willingness to have confidence in the company and buy when the shares are under pressure, adding to your position is extremely powerful. It's kind of counterintuitive to the way the market operates. If Macy's were to have a sale, half-price, people would rush in, and when stocks go down people tend to sell.

It's really the Peter Lynch theory that you watch what's going on and you buy shares of good companies and hold on. It didn't take a lot to identify that Google was quite a visible company whether you like the price or had confidence in what they were trying as their business strategy is a whole other issue. I think the person who wants to do this, or the investor who wants to do this, has to be willing to venture out on their own, do their own research and make their own decisions. They're not going to have as much information as the hedge funds or the money managers with huge research staffs, but they may have a dose of common sense, which could help a lot.

The people who really succeed, like in any field, are those who have a passion and spend a lot of time - and I think you can do that as an individual, but it's not easy. I would say the two key factors are understand your own situation and also have control over your emotions - understand how you make decisions, look at your record over time, and sort of adapt your strategy to that." [end box]