

Star Gazer Jack LaPorte – Portfolio Manager for the New Horizons Fund at T. Rowe Price

Jack has been managing the \$6.3 billion New Horizons Fund at T. Rowe Price since 1987. In his reign, Laporte has delivered an 11.8% yearly return, 1.6 points better than the S&P 500 and 5.5 points better than the Russell 2000 Growth Index.

“What I’m looking for is companies that I can invest in and own for a long period of time. And because I’m taking that longer term focus, I’m looking at a number of different characteristics. Generally, for a successful, rapidly growing small-cap company, I’m looking for a founder who is a visionary and entrepreneurial CEO who’s come up with a unique, industry-changing business strategy, I’m looking for companies that can hopefully, have decent cash flow and hopefully they can finance the majority of their growth internally. I don’t like capital-intensive companies. I like companies that operate in very large fragmented industries where there’s an opportunity to gain share over time. I like businesses with high recurring revenues. I like companies with above-average profitability in terms of ROE or ROIC and I like sustainable, organic sales and earnings growth.

Business and consumer services sectors were some of my most successful investments going back in time and I think the opportunities are still there going forward. The great thing about most service industries is they are not capital intensive so if it’s a question of ability to raise capital and invest capital to gain a competitive edge, larger companies tend to have an advantage, but when success is not determined by the ability to have capital to invest in an industry, which is the case in many service industries, then it’s whether you have a better management, a better business strategy, have better internal corporate culture, those factors are going to help determine success, and most of those service industries have that. A nice thing about a lot of these service industries is because they’re so fragmented, oftentimes there are higher organic growth opportunities, but many of the companies can supplement the organic growth by making acquisitions to help consolidate some of these service sectors and that often is a supplemental way to help grow the businesses over a long period of time.

The management team is critical in investing in small cap companies. What I’ve found is an excellent management team in a small company can do well operating in a mediocre industry category. One that comes to mind is 10 or 15 years ago I invested in several small steel companies that had a unique business model which was a mini-mill, less capital intensive business model for the steel sector, and they took incredible share...

The flip side is also true in that a management team that doesn’t have its head screwed on right can screw up the best of businesses and fritter away shareholders’ capital. Oftentimes however those companies need to make a transition to a management team that can manage the growth beyond the evolution of the business idea, and there’s often a need to turn the management over to a more professional management team from the entrepreneurial one that created the business to begin with. I can think of some examples of that whether it’s Apollo Group where the Sperlings really came up with the idea, but then they kind of backed away and turned the management of the company over to a more professional management team. I’ll never invest in a company unless I’ve met with the management face-to-face.

Apollo Group was certainly a major winner, which we invested in on the IPO back in December of ‘94, and while the company has struggled for the last 18 months, it’s still up almost a hundred times since the IPO. What I’m trying to do in running New Horizons and something that I think distinguishes the way I look at managing a small cap growth fund from how others invest. I’m looking to invest in companies that I can own for a long period of time 3-5 years, or in many cases even longer, in Apollo’s case, it’s over 10 years. Many of my top ten holdings I’ve owned for 5-10 years and the benefit of that is when you find a great company that can compound their earnings at well-above average rates, really the shareholders benefit if you hold it for a long period of time. The way the math works when I look at what growth investing is, it’s really taking advantage of the power of compound earnings growth. That, in a nutshell, is what it’s all about. As you know, if you own a company whose earnings can grow at 15% a year for 10 years, after 10 years, the earnings will have quadrupled, so if the P/E stays the same, the stock would quadruple. If you can find a company that can grow its earnings 20% a year for 10 years, those earnings will be up 6 fold over 10 years, and so the stock at a constant P/E’s going to be up six fold. So to transfer that into Apollo’s case, Apollo’s earnings compounded at around 40% a year for 10 years, P/E expanded a little bit, and lo and behold, that turns into a 100 factor. Where I think most growth investors, so-called growth investors, fall down is they don’t think about the power of compound earnings growth they think about

kind of trading into the latest fad or the latest sector that is showing above-average growth. The thing that distinguishes New Horizons is that the average turnover rate in the portfolio is about 25% a year now, meaning that I hold a stock for an average of 4 years. I don't see how you can do well as a growth investor just churning the portfolio so rapidly.

A mistake which I think many growth investors make is often they are not will to pay what they should for at truly unique outstanding growth company. If you think about what I said earlier about the power of compound growth, if you find a company that can grow their earnings at 20% a year for an extended period of time and have a high degree of confidence that that can happen, you should be willing to pay a very high P/E on current earnings. I think I fall under the trap sometimes of saying, "Ah, this is a great company with a great management, but it's too expensive." Well if it really is a great company with a great management, you should want to look through the current price which might look a little big expensive on current earnings and realize that if you're buying it on the basis of earnings out two or three years, it's actually very cheap.

Another mistake that investors make which would be not being willing to pay enough for a great growth company and not holding their great stocks long enough. The best example of that for New Horizons Fund, way before I even joined T Rowe Price, New Horizons Fund bought Wal-Mart on its IPO back in 1969-70 we held the stock, although we trimmed it along the way, we held it until I think 1983. We made a ton of money, it was a very successful investment., but we finally sold it because it could no longer be called a small company, that was in 1983. When I look back at that sale and had my statistician go back and look at that sale, about 15 years later, what we found was that if we had held our maximum Wal-Mart position, it would have been bigger than our whole fund! [end box]