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MUTUAL FUNDS

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Investment Guides

Growth essentials

Mackenzie Investment Guide

Growth investing

"Our sights are set on companies that will benefit from the specific trends or themes we think will be important over the next decade. When we identify a company that has, in our view, a fairly valued stock, industry dominance, distinct competitive advantages and an ability to capitalize on or create a new technology or trend, chances are good that we've found a winner."

Ian Ainsworth, Lead Manager, Mackenzie Universal Future and Mackenzie Universal Global Future funds.

Understanding the growth label

In order to understand the growth label on mutual funds, it helps to understand the various ways in which funds are classified.

History

In the 1950s and 1960s, there were very few mutual funds in Canada, and most had very broad investment mandates. It was the job of a fund manager to act on behalf of a group of clients and use his or her security selection capabilities to produce a reasonable return. If that return came from owning more bonds than stocks, so be it–that was the manager's call.

Today, as the mutual fund marketplace has expanded and evolved, consumers and advisors have required that fund managers be very specific (or at least, more specific) about what they do. Very few investors buy just one fund anymore, so funds are often designed to play a specific role or have particular risk-return characteristics in order to fit into a portfolio of funds and other investments.

Focusing on growth and value

Academic researchers often define value stocks as those with a low ratio of price-to-book value and growth stocks as those with a high price-to-book. (Definition: book value refers to a company's assets, minus any liabilities and intangible assets, per outstanding share). In addition, growth stocks typically have higher price/earnings (P/E) ratios than value stocks. In other words, value stocks represent a bargain hunter's approach to investing: buy stocks that are selling cheap relative to their assets with the expectation that eventually other investors will recognize this discrepancy and correct it by pushing the stock price up. Growth investors attempt to identify businesses with the best future earnings prospects and believe that the market will continue to pay a premium for the best growers in the future. There are wide differences among growth managers in the price they are willing to pay for growth.

These are the most basic definitions of growth and value: expensive vs. cheap; future earnings vs. assets. But the reality is a good deal more complex. Even the originators of value investing, Graham and Dodd, in their 1934 classic *Security Analysis*, stated that it is important to assess "favourable possibilities for future growth." [1] Today's managers employ a wide array of analytical tools to support their analyses, with literally dozens of ratios, indicators and qualitative factors in the mix. Indeed, many growth managers employ value measures to aid with their "sell" decisions and many value managers employ some growth-type analysis to determine what the catalyst will be that will make the value of a stock emerge in future years. There are conservative growth managers who avoid deeply cyclical industries and place great emphasis on consistency; there are aggressive growth managers who pay steep premiums to participate in the growth of companies on the verge of dominating their businesses.

A few ways to define funds

Asset class: bonds, stocks, income trusts, real estate, mortgages, treasury bills, alternative investments, venture capital

Geography: global vs. regional funds

Within bonds

Issuer: corporate vs. government issues

Credit quality: low to high

Within stocks

Market capitalization (i.e., company size): small cap (e.g., <$1 bn. market cap), mid cap (e.g., $1 bn. to $10 bn. market cap), large cap (e.g., >$10 bn. market cap)

Sector: healthcare, financial services, natural resources

Style: value, growth, blend

Growth investors attempt to identify businesses with the best future earnings prospects and believe that the market will continue to pay a premium for the best growers in the future.

The growth label (cont.)

A manager's tool kit

Here are some of the analytical tools at a manager's disposal:

Fundamental analysis: reviewing past financial statements to ascertain trends in earnings, profitability, sales and debt.

Technical analysis: charting stock price movements and trading volume over time to determine trends in investor behaviour with respect to a stock.

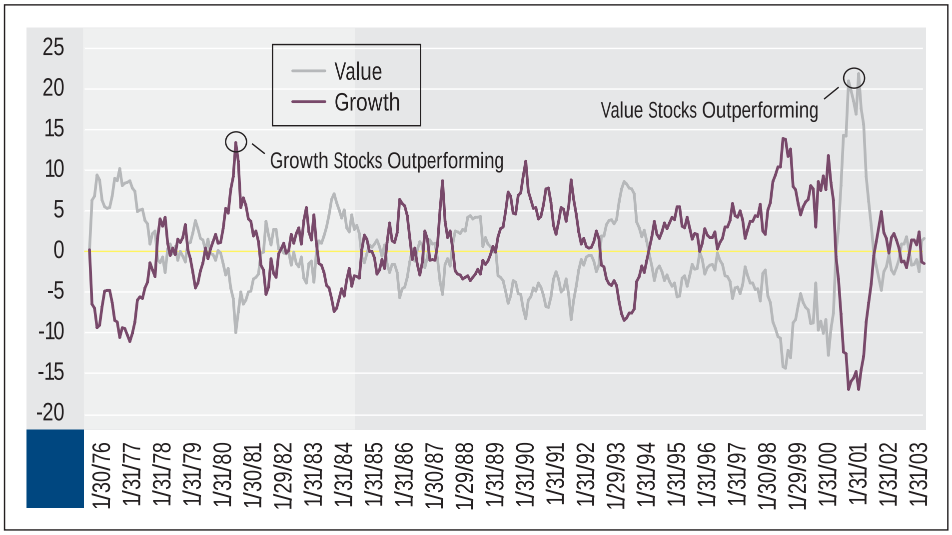
Qualitative analysis: reading industry journals, attending trade conferences and speaking to industry competitors, suppliers and customers.

Top-down macroeconomic analysis: reviewing trends in consumption, interest rates, government policy, resource supply, political developments, etc.

Getting back to the basics of why growth is important

At various times since the 1970s, academics have tried to provide advice on which approach is better, growth or value. In the early nineties, many academics concluded that value outperforms growth, and prompted a policy shift by some institutional investors to overweight their portfolios in value (as represented by stocks with below average price-to-book)[2]. Unfortunately, this shift occurred at the start of a six-year period in which growth significantly outperformed value (1993-1999). The 2000-2002 stock market correction, in which growth-oriented technology stocks were particularly hard-hit, represented another leadership change, and value stocks were again on top.

The lesson from the Barra Growth vs. Value chart seems to be that growth and value often exchange leadership and that the timing of these crossovers is unpredictable even for experts; therefore, we believe, some style diversification is important. Another lesson that doesn't appear in the Barra chart is that quality management, in both growth and value, is key.



GROWTH AND VALUE REGULARLY EXCHANGE LEADERSHIP; THE TIMING OF THESE CROSSOVERS IS UNPREDICTABLE

Source: S&P / BARRA

The chart illustrates the performance of growth vs. value stocks, relative to the overall index. The red line indicates periods when growth stocks have outperformed, using rolling 12-month returns of S&P 500 stocks with high price-to-book value; the grey line represents relative returns of stocks with low price-to-book (i.e., value). Over the long term, both growth and value have worked. From Jan. 31, 1975 to Jan. 31, 2003, avg. annual returns (compounded) were: S&P 500 Barra Value: 8.70%/yr; Barra Growth: 9.09%; Composite: 8.98%.

It’s all in the execution

A veteran practitioner’s take on growth investing

Twenty-five-year veteran manager Ian Ainsworth, lead manager of Mackenzie Universal Future and Mackenzie Universal Global Future funds, is definitely in the growth camp. His approach to growth is one among many available at Mackenzie. A two-time Fund Manager of the Year*, Ian uses both top-down research to identify growth themes and fundamental research to find the best opportunities. Here are some of the global growth themes that Ian and his team have identified:

China
- A magnet for capital investment
- Infrastructure upgrading rapidly
- Moving to private enterprise
- Growing middle class
- Imports from Asia accelerating

Technology
- Moore’s Law** hasn’t gone away
- A vast digital transition is just beginning
- Nanotechnology

Healthcare
- Sequenced human genome will drive therapies
- Thousands of new targets

Alternate Energy
- Hydrogen, nanotube batteries, solar power and wind turbines

Resources
- Oil in short supply
- Metal inventories low
- Drinkable water getting scarce

Incorporating risk management

“We look for companies with the right combination of attractive valuations and earnings potential. Whether it’s a big company exhibiting stable growth or a niche player with the potential for new growth, attractive valuations occur when a stock’s price doesn’t fully account for the company’s earnings potential. We’re carefully targeting companies with a lot of fuel for growth.”

—Ian Ainsworth

A key component of successful growth investing is risk management. As Ian points out, a growth investor is investing in the future—future earnings, future industry dominance and future economic trends. In order to balance participation in growth companies with the need to control risk, Ian and his team classify companies into three tiers and ensure that they are not overexposed to the most risky tier.

Tier 1
- Growth leaders: broad product lines, strong balance sheets and dominance in their sectors
- 50-80% of the fund’s portfolio

Tier 2
- Strong companies with good balance sheets; generally narrower product lines
- Passed the critical point of developing a strong management team
- Potential to become Tier 1 companies
- 10-40% of the fund’s portfolio

Tier 3
- Usually smaller capitalized companies driven by niche growth opportunities
- Offer good opportunities in a mature economy
  - 0-25% of the fund’s portfolio

A key component of successful growth investing is risk management.

* Canadian Investment Awards

**Moore’s Law refers to the fact that the number of transistors per integrated circuit continues to double every couple of years, in turn driving improvements in all information technology.

Growth as a means to diversify

Summary

The distinction between growth and value styles represents one way of classifying your equity fund holdings. Furthermore, there is a tremendous range of management approaches within each style camp. It is more productive to maintain a level of style diversification than to try to reach a conclusion as to which method works better. In the end, the success of each style boils down to execution.

A selection of Mackenzie's growth-oriented funds

Mackenzie Universal Future Fund
Manager: Ian Ainsworth and team
Core Canadian growth equity fund

Mackenzie Universal Global Future Fund
Manager: Ian Ainsworth and team
Core global growth equity fund

Mackenzie Universal Canadian Growth Fund
Manager: Dina DeGeer, Dennis Starritt and Phil Taller of Bluewater Investment Management
Core Canadian growth equity fund

Mackenzie Universal US Growth Leaders Fund
Manager: Phillip Sanders and Daniel Becker of Waddell & Reed Inc.
Core US growth equity fund

Mackenzie Universal Growth Trends Capital Class
Manager: Alliance Capital Management
Core global growth equity fund

References

1. *The Journal of Investing*, Winter 2001. "Are Growth and Value Dead? A New Framework". Lawrence S. Speidell and John Graves.
2. *Ibid*.

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