



March 27, 2008

Investing With Conviction in Mid Caps

Knowing companies inside and out is the key for Optimum's Zerhusen

Thyra Zerhusen, manager of the Aston/Optimum Mid Cap Fund, is a pure, bottom-up stock picker. An independent thinker who questions conventional wisdom and acts on her instincts, she scours the mid-cap universe for companies with sustainable competitive advantages that reflect her core investing principles-strong revenue growth, low debt, and proven management teams. As important, she adds a level of conviction to those principles not typically found among portfolio managers. That conviction manifests itself in the strategy's concentrated portfolio and relatively low turnover of holdings.

Morningstar Study

In 2004, independent fund researcher Morningstar published an article highlighting the results of a study it conducted entitled "Investing With Conviction." The purpose of the study was to attempt to measure empirically the benefits of what intuitively appeared to be an important aspect of the investment process shared by a number of highly successful managers. Citing Warren Buffett, among others, as inspiration the study looked for mutual fund managers willing to bet on just a few dozen of their best ideas and to stick with those stocks over a lengthy time horizon. Using its extensive fund database Morningstar combined two measurable aspects of this type of conviction—low turnover rates and relatively concentrated portfolios—to see how this type of strategy had performed.

The results were striking. In measuring rolling five-year return data from 1992 through 2003, gross of fees, managers that invested with conviction had outperformed their respective Morningstar category averages more than 80% of the time across six of the seven domestic equity categories containing a meaningful sample size. The study credited the ability of management to know the companies it owned extremely well and the lack of a need to follow hundreds of potential replacement ideas due to lower than average turnover as factors in favor of this approach. In addition, it pointed to the likelihood of less dilution on returns from lesser ideas in the portfolio or the risk of bad timing caused by more-active trading. (Note: Past performance is not a predictor of future results, and funds that employ this strategy are not guaranteed to experience favorable returns.)

The Market's Sweet Spot

As the Morningstar study implies, however, conviction alone doesn't lead to investment success. Portfolio construction matters little absent the ability to pick superior performing stocks. But employing a concentrated, low-turnover approach does allow a manager time to analyze holdings and new ideas more in-depth. Zerhusen agrees, believing that a fund with roughly 40 stocks has sufficient diversification yet is small enough not to lose track of any names. Time is an important factor for her given that many of the fundamental traits that she emphasizes in companies don't lend themselves well to quantitative screening.

Zerhusen looks for non-diversified businesses with strong, or as she would say, essential products that are able to deliver top-line growth in units and revenue. She wants to own a firm focused on its competitive advantages, thereby enabling it to increase market share. Experience has taught her that diversified business lines often distract management and resources away from the core product. This she finds an especially important factor with mid-sized companies, where management seldom has the depth to diversify successfully, and there is typically plenty of room to grow in the core business. Experienced management is extremely important in terms of having faith in their ability to execute. Given the strategy's intended long holding periods, Zerhusen typically gets to know management teams quite well.

¹ Kerry O'Boyle, "Investing With Conviction," *Morningstar FundInvestor*, July, 2004, 8-9.

As noted, this bias toward niche business naturally leads Zerhusen to mid-sized companies. Unlike other so-called mid-cap strategies that invest in stocks of all sizes that then average out to a middle market capitalization, this strategy truly invests a substantial amount of assets in mid-cap stocks. Indeed, she thinks that mid-sized companies--while potentially more volatile and less liquid than bigger firms--possess a number of inherent advantages, and function as sort of a "sweet spot" within the market. Relative to large-caps, these companies typically offer better access to management, inefficiencies in the stock price due to less coverage by Wall Street, and superior growth. At the other end of the spectrum, small-cap stocks tend to be less liquid, more volatile, and run by less experienced management teams. Zerhusen seeks to benefit from opportunities in this area by digging deeply into the fundamentals and getting the qualitative calls on management and the business model right.

Buffett's Definition of Risk

A common concern with any concentrated approach is risk, which many define as volatility. While investing with conviction certainly entails the potential for relatively higher volatility than rivals and the benchmark, is past volatility really an effective measure of future risk? As the Morningstar study mentions, Buffett doesn't think volatility matters if one is willing to hold on to a stock for many years. He defines risk as permanent underperformance from either paying too much for a stock or buying into a company that suffers a long-term decline in earnings.

Zerhusen shares her appreciation for the importance of valuation, and controlling risk is primarily a function of her bottom-up, fundamental style. Even when she finds a company that fits her preferred profile, she only buys when its stock trades at an attractive valuation across a variety of metrics, including relative price/earnings and price/earnings to growth. Zerhusen considers herself conservative in her approach to valuation, and confesses to spending as much time worrying about what could go wrong with a stock as she does its upside potential. She does set valuation targets, which when exceeded can act as a sell trigger, as does any deterioration in fundamentals or loss of confidence in management. In addition, she prefers to own companies with minimal debt. This not only can help a firm to survive during tough times, but can also allow it to make value-enhancing acquisitions.

Moreover, while the companies the Aston/Optimum Mid Cap Fund owns are mostly non-diversified, the end markets for their products typically are not. A significant percentage of current holdings in the portfolio derive more than half of their profits from overseas--highlighting the high demand for their "essential" goods. Thus, these companies have the potential to continue to deliver solid growth if the US economy continues to falter.

Portfolio For the Long Haul

Still, investors need to be as disciplined as the fund manager to reap the full benefits of this strategy. That means investing for the long haul. As seen recently, stock prices can fluctuate wildly in the near-term, regardless of whether they present a long-term opportunity or not. Although in general the Morningstar study covered a relatively prosperous time in the history of the equity markets, it did include the 2000 to 2002 bear market. During that time, managers with conviction still managed to outperform the category average--though to a lesser degree--and volatility, while still above average, lessened considerably from the boom years of the 1990s. That downward volatility may not be as severe with such a strategy gives strength to the argument that during rough times it might pay to hold a relatively small number of carefully selected stocks than be exposed to a broader, more index-centric approach.

Article written by:

Kerry O'Boyle is an Investment Strategist with Aston Asset Management. Prior to joining Aston he wrote on a variety of investment topics as a Mutual Fund Analyst for Morningstar, Inc. Kerry is a graduate of the U.S. Naval Academy, and holds an M.A. in Liberal Arts from St. John's College, Annapolis, MD.

Investors should consider the investment objectives, risks, charges, and expenses of the Aston Funds carefully before investing. Please call 800-992-8151 for a prospectus, which contains this and other information about the Funds. Read it carefully before you invest or send money. Distributed by PFPC Distributors, Inc., which is not an advisor affiliate.