Aston Funds

Spotlight

December 1, 2008

A Manager For All Seasons

Montag & Caldwell adheres to investment principles focused on sustainable earnings growth.

Any manager can ride a speculative boom to its heights and then give it all back during the subsequent bust. It takes skill and discipline, however, to earn and preserve superior performance over a full market cycle. The skill comes in identifying those stocks able to participate in a growing economy, but also steady enough to weather tougher times. Discipline is required to avoid the excesses of booms and the hubris that results from success amid an environment where all boats rise with an exuberant tide. Montag & Caldwell has displayed such skill and discipline investing in large-cap growth stocks, with a record reaching back more than three decades.

Montag has achieved that success by seeking strong secular and cyclical growth companies—manifested by earnings sustainability and earnings momentum—at reasonable valuations. Their process is designed to spot unrecognized growth in high-quality companies trading at a discount to a proprietary calculation of fair value, with the catalyst of faster near-term earnings growth than the overall market. Quality, in their view, is superior long-term earnings growth and the steadiness of that growth rate projected over the next 10 years. Valuation is important in that, as one analyst has noted, "[Montag] understands that even growth stocks have to be bought at the right price."[1]

In practical terms, Montag measures quality using an 11-factor financial score—including historical long-term growth, earnings predictability, balance sheet strength, and profitability—that also serves as the basis for a stock-specific discount rate used in the firm's valuation model. Montag developed this model after the crash of the so-called Nifty Fifty stocks during the 1970s revealed the need to consider absolute valuations, in addition to relative valuation measures such as price/earnings, in order to better control risk. Seeking the best combination of high-quality, above-average earnings growth and valuation (both relative and absolute) allows them to adjust to differing market conditions, with relative earnings momentum serving as a timing device that enables that growth potential and value to be recognized by the market.

Avoiding Excesses

Montag relies on detailed fundamental analysis from its six-member research staff to support its models. Led by veteran stock-picker and Chief Investment Officer Ron Canakaris, a consensus decision by the 11 veteran portfolio managers in the Investment Policy Group is required to implement changes in the portfolio. This team-based approach provides an added layer of rigor and consistency to the investment analysis, and helps to ensure the continuity of the process. That's critical when projecting 10 years out to determine the key inputs in assessing a firm's earnings quality.

Such a long-term outlook and disciplined approach, however, keeps Montag from getting caught up too much in overly exuberant markets such as those seen during the late 1990s and 2003-2004. During such periods, quality and fundamentals are often left by the wayside in the rush for immediate, and often fleeting, gains. While the Internet bubble is now clearly viewed as a period of excess, only recently have the overindulgences of the latter period come into question.

The post-2002 bear market rally is quickly becoming recognized as one of false prosperity amid booming financial stocks and corporate profits built upon the shaky foundation of easy credit, extreme leverage, and runaway asset prices. Indeed, one well-regarded commentator recently called the market advance from late-2002 to 2007 "the biggest sucker's rally in history," on the belief that the excesses of the technology bubble were never fully worked out of the market before "enough stimuli to get the dead to walk" inflated another bubble.[2] Such conditions always end badly, it just took far longer than even the most hardened skeptics expected for this latest house of cards to come crashing down. Quality large-cap growth stocks suffered the most during this "false rally" as value stocks—driven by financials—outperformed, and small- and mid-sized firms became the darlings of the marketplace.

Finding Quality Growth Now

Despite these periods of excess, investors do eventually return to the comfort of companies with strong balance sheets and steady earnings growth—and not just during bear markets. Amid the prosperous but less exuberant times of the early- and mid-1990s, Montag found quality secular growth among big, domestic-based companies with a global reach that went on to earn huge profits from the beginning of globalization and the rise of emerging markets. Now, they're looking globally again—to large, multi-national corporations based in the US that can benefit from significant worldwide exposure. Montag believes that global growth will offset some of the current weakness in US markets, and that growing middle-class populations and increasing standards of living in emerging markets (which comprise 60% of the world's population) will drive secular growth going forward.

That's not the normal route out of a US economic recession. Indeed, Montag has been adamant that the traditional growth playbook of investing in early-cycle stocks—financials, homebuilders, autos, retailers—won't work this time. The Financials and Consumer Discretionary sectors have benefited immensely from the "phony" growth derived from lax lending standards the past few years, and the economy can no longer rely on leverage or a tapped-out US consumer to boost these areas and the world out of recession.

Montag balances this long-term secular growth view with a slug of cyclical growth stories as well. Whereas they were early into technology during the 1990s on the prospects of the transition from hardware-oriented mainframe computers to client-server distributed data architecture and data processing firms that would go on to fuel the Internet and lead a decade long boom, they now view tech as a mostly mature and unattractive opportunity. The one exception offering reliable growth is smart-phones, where the strategy gets exposure through firms such as Apple, Research in Motion, and Qualcomm. In addition, they think it's too early to count out the Energy sector, where global spending on services and exploration continues to be strong in the face of increasing concerns about worldwide supply.

Where Are the Large-Growth Champions?

There a Two recent, extreme periods of speculation have conditioned many investors to think that growth investing equals 20+% earnings acceleration and stock price momentum. While certain groups of stocks can, and have, provided such quick bursts of growth from time to time, that growth is rarely sustainable. History has shown the difficulty of consistently trying to time moves into and out of such fast-growing yet short-lasting areas of the market. As evidence, ask yourself where are the longtime success stories—the Warren Buffetts—of the growth world? What's happened to the star growth managers of the late-1990s? While heroes are often fashioned amid short-term speculative run-ups, few actually stand the test of time.

For the past three decades, Montag & Caldwell has adhered to a set of principles that instill discipline and consistency into its investment process. Combining quantitative and qualitative measures and a team of experienced professionals to execute that process, Montag seeks growth through companies that have proven capable of delivering consistently above-average earnings. Thus, while other growth managers tempt fate by flitting from one growth fad to another, Montag believes that sustainable earnings bought at reasonable valuations and propelled by near-term catalysts will win out over the long haul.

[1] Kunal Kapoor, M*orningstar Fund Analysis—Aston/Montag & Caldwell Growth Fund,* March 23, 2004.
[2] Jeremy Grantham*, Reaping the Whirlwind,* GMO Quarterly Letter, October 2008.

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.

Past performance is no guarantee of future results. Montag & Caldwell is an unaffiliated subadvisor to Aston Asset Management and the Aston Funds.The information in this report should not be considered a recommendation to buy or sell any particular security. Holdings and weightings are subject to change at any time and without notice. For more information about Aston Asset Management LLC and its subadvisors, please call 800-597-9704, or visit www.astonfunds.com