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MARKETS

3 High Quality Growth Stocks With Reasonable Valuations

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Monica Walker: The American Beacon Holland Large Cap Growth Fund is a large cap growth fund where we employ a high quality conservative growth strategy. What we mean by that is we're looking for high quality companies that can grow their earnings by double digits and that we can buy at a reasonable valuation.

The fund's inception date was 1996 and we've been employing this strategy from the beginning. The strategy has allowed us to, in exuberant or strong bull-market environments or strong or extended periods of rising prices, meaningfully participate in the rise.

But at the same time, with that conservative growth strategy, we've been able to protect on the downside so that in extended periods of declining prices, or bear-market environments, we've performed relatively better than more aggressive managers and better than our benchmark, which is the Russell 1000 Growth Index.

Wally Forbes: Monica, do you have any limitations in terms of the size of the companies in which you invest?

Walker: Yes. We buy companies that have $1 billion in market capitalization or greater. So we'll go to the very largest, but we'll buy some at lower ranges as well. If you look at the history of the

portfolio over a long period of time, we have historically had about 30% to 40% in what could be classified as mid-cap stocks. In many instances, some of those companies are growing even faster than the larger companies. However the dollar-weighted average market cap of the portfolio is generally consistent with other large-cap growth managers.

One of the things we look for in companies is good management teams. That's very important to us. We want management to be disclosive and also have a history of being shareholder oriented, but also able to perform well, not only in good environments for their business, but also in tough environments.

I mentioned earlier that we like companies that have double-digit earnings growth that are selling at reasonable valuations. That's also important to us and is one of the things that help protect the portfolio on the downside, that conservative valuation, not buying earnings at any price, but at a reasonable valuation.

Forbes: That sounds value oriented.

Walker: Yes, but always with growth in the forefront. It's growth with value, actually — growth and then value. We like companies in strong financial condition, with solid balance sheets, strong free cash flow, and good return on equity. Those things are important to us as well as low levels of debt.

And we like companies that have niche products or services or have some competitive advantage or positioning in the industry or sector in which they operate. It's also very good when our companies have ownership in the hands of the key management, and also even in at the mid-management level. We just think it's important for those that are running the business to be vested in their own cooking.

We use a team-oriented process. So although I am one of the portfolio managers, Carl Bhathena is the co-portfolio manager. And we have a team of four talented and experienced analysts that work with us. It's this six-person team of co-portfolio managers and analysts that perform the research that identifies companies for the portfolio.

We are bottom-up, fundamental stock pickers, which means that we're really interested in delving into the companies, looking at their income statements, balance sheets, looking at their profitability, their competitive positioning, the segmentation of their business, and their business model. It's this bottom-up fundamental research that drives the stock decisions we make in our portfolio.

Forbes: Do you have any limit on the number of stocks in the portfolio?

Walker: We generally will own plus or minus 50 stocks. We would generally not have more than 5% in one name and generally not more than 30% or so in an individual sector. Those are some of the risk limitations that we employ.

Forbes: Well maybe you can get into some of the stocks that at this point look good to you.

Walker: Visa (NYSE: V) is a name that we've owned since it went public in March of 2008. As you probably know, it has the world's largest payment processing network called VisaNet. And it processed, at least in 2012, about $6.4 trillion in volume. It's huge. They also have the capability to process about 24,000 transactions per second. There are about 2.1 billion Visa-branded cards that are actually in the hands of consumers worldwide, which is by far the largest number even if you look at the number-two player, MasterCard, which only has about half that number.

So really Visa obviously has a leadership position in the space and that's one of the things we like about the company. We also think it's very compelling because it participates in the electronification of payments, a trend that's continued since the stock went public in 2008. And during that time, Visa has been able to grow its revenues at a compounded annual growth rate of about 14%.

And actually its earnings even doubled that at about a 29% compounded annual growth rate since it went public. There really aren't very many companies of Visa's size — about a $119 billion market cap — that can even grow their revenues at double-digit rates. But Visa's been able to do this and we think they should be able to continue to do it going forward.

We anticipate them growing revenues about 10%, earnings in the teens. And we think they'll continue to participate in this whole growth in the electronification of payments. They're also very well-positioned because they have 45% of their revenues outside the U.S. and very limited exposure at this point to Europe. So with that broad international exposure, they'll be able to continue to participate in the trend.

Forbes: Diversification.

Walker: Yes. They're very defensive. We like that. They don't take on any credit risk, despite the fact that they're a credit card payment processor. That's very important to us. We try to shy away from companies that have credit, mortgage, and housing exposure at this point.

Their barriers to entry are very high because they have built a very large-scale operation that would be extremely difficult for any new competitor to replicate. They have a lot of cash on their balance sheet. They have no debt. They have very high and healthy operating margins and a very strong return on invested capital.

Forbes: You make a strong case.

Walker: Yes, we think at these valuation levels, looking at the company's quality and its growth attributes and defensiveness, we think it's a relatively good investment for the portfolio.

Forbes: What other ones do you have a positive view of at this point?

Walker: Another company would be Covidien (NYSE: COV). Covidien is in the healthcare space. It was a spinout of Tyco in 2007. And it mainly operates in the area of medical devices, which currently represents about 68% of their business. And they have a specialty in surgical tools within the medical device space.

They also have a pharmaceutical division, Mallinckrodt, which is expected to be spun out by the end of June. And they also have a medical supply business. We anticipate that after the spin-off of the pharmaceutical division, Covidien will be mainly a medical device company. 80% of their business revenues will be medical devices and 20% will be medical supplies.

Now, we're thinking that the medical device business will grow in the mid-to-high single-digit range, while the medical supplies business will grow in the low single-digit range. When the company spun out of Tyco, one of the things that they wanted to do as a standalone company, was to reinvigorate the business through investment in R&D. Their R&D rates were low because the business segment, itself, was under the umbrella of a bigger company. Management wanted to increase R&D, which they have, to more significant levels that could drive new products, and to also increase their SG&A spending to build a bigger sales force. Then they want to thoughtfully and carefully look across the divisions within the company and divest of low-margin, low-growth businesses.

They have successfully been able to do these things, as well as completing a series of bolt-on acquisitions — small acquisitions to bolster their medical device business. And this has allowed the company to increase its growth rate.

Forbes: Are they international also?

Walker: They do have business internationally. Currently about 16% of their business is in the Asia-Pacific area, in the emerging markets, and about 6% in the rest of the world, and about 22% in Europe. So they do have significant exposure outside of the U.S., and one of the good things is that they are investing heavily in the emerging markets. That particular part of the business is growing 15% to 25% annually.

We anticipate that they'll continue to invest in those markets because it's a growth opportunity for them. And we think they'll continue to do bolt-on acquisitions and continue to spin off lower-margin, slower-growing businesses so they can continue to increase their growth rates.

The stock is selling at a pretty reasonable valuation right now, at about 14.4 times their next 12-months estimated earnings. And we're expecting that with about 6% to 7% top-line growth, continued margin improvement, and some accretive bolt-on acquisitions, that they'll be able to grow their bottom line 10% to 13% over the next three to five years.

And we think one of the other things that may help the company is that once they spin off the pharmaceutical division, Mallinckrodt, investors will look at the company as more of a pure-play medical device company, which could mean a higher multiple.

Forbes: Sounds like another strong case. Have you got one more?

Walker: One more company that we like and that's in our top-ten holdings is Range Resources (NYSE: RRC). Range Resources is an exploration and production company, mainly in the natural gas space. We did research on the company in 2005 and we purchased it for our mid-cap growth portfolio. At that time, based on our research, one of their very active plays was in the Appalachian Basin. And for a mid-cap growth company, they had a pretty attractive cost structure.

But subsequent to that, they announced the discovery of the Marcellus Shale, which now appears to be the second or third largest natural gas play ever, worldwide. Range has been able to build a large acreage position in that play. So during the crash of 2008, given that the price of the stock had come down significantly and they had recently announced the Marcellus play, we decided to add it to our large-cap portfolio, which is the portfolio we're talking about today.

One of the things that we look for in exploration and production companies, given that we're a high-quality, conservative growth investor, are companies that have deep inventories of low-cost wells to drill. If a company is able to stay on the low end of the cost curve within the individual commodity, whether it's oil or gas, they'll be able to weather cyclical downturns in oil and gas prices much better than their competitors.

And as well, if they are at the low end of the cost curve and they have high returning projects, they'll be able to even generate more cash flow per unit of production, which if they happen to have deep inventories, can lead to faster growth if the company can continue to deploy that capital back into drilling their inventory.

Range Resources has all three of those attributes. They operate at the very low end of the cost curve and then they have a number of plays or projects that have some of the highest returns in North America. For instance, the Southwest Marcellus liquids-rich play is a very high-return project. And then the company's Mississippian Oil play is also among the higher returning plays in the country. So on the cost side, they look very good. On the return-on-project side, they look very good. And they have a deep inventory of properties, of exploitable resources. For instance, the company has, and I know these are big numbers, 6.5 Tcfe (trillion cubic feet equivalent) in proven reserves.

And that doesn't even include the probables and possibles, which could potentially be about eight to 12 times that. So one way to think about it is if you assume a total resource potential of 60 to 64 Tcfe, they will only produce about 340 Bcfe (billion cubic feet equivalent) in total for 2013. That means that they have about 180 years of resource, given the current production rate that they're experiencing.

And the majority is in high-return, low-cost projects. There's really not any other company that can come close to their resource potential. And we have a lot of confidence that the company can continue to grow their production for a very long time. Management indicates that for the foreseeable future, they can grow production 20% to 25% per year. If they do that, they'll be able to double their production every three years.

Five or six years out, they should be producing about 3 Bcfepd (three billion cubic feet equivalent per day), which is really huge. And if they do that and they continue to drill out more low-cost inventory and build scale, their per-unit cost should decline. So not only will they be producing at higher levels, their costs go down and then their per-unit margins increase and more earnings and cash flow creep to the bottom line.

Forbes: Monica, those sound like three very compelling examples of your strategy.

Walker: Yes, they all have been solid contributors to our portfolio and we hope they continue to do so in the future.

Forbes: I think our readers will be very interested to get your input. And I want to thank you for taking the time to join us.

Walker: Thank you.

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