BUY SIDE

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Well-Timed Profits

by Sandy Serva


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General Partners Ryan Willson, Scott Chapman, Roland Underhill, Justus Leachman and Khateeb "Al" Lateef

Lateef Management Associates

A Chinese proverb says, "With time and patience the mulberry leaf becomes a silk gown." The money management team at Lateef Management Associates (LMA) understands the wisdom behind this deceptively simple statement. After all, time and patience are critical components to its proven investment strategy.

"We not only find good businesses, but we try to determine at what point we should buy them," says Al Lateef. "Identifying good companies is simply not enough — you have to buy them at the right price. That's when 90% of the problem arises — when you simply pay too much for a good company."

Growth at a reasonable price is the investment style that continues to serve the firm well. Founded in 1974 by Lateef, LMA currently has approximately $575 million under management, handling the investment portfolios of individuals, corporations, employee benefit plans, charitable foundations and academic endowments. Nelson Information, a database of more than 2,600 money managers, named LMA to its list of "World's Best Money Managers" for the fifth quarter in a row in March 2002, and Money Manager Review, a database of more than 800 money managers, ranked the firm No. 1 of all Multi-Cap Growth Managers for risk adjusted returns for three-year, five-year, seven-year, and 10-year periods ending March 2002, and No. 1 for all U.S. Growth Managers for risk adjusted return for the seven-year period ending March 2002.

General partners Al Lateef, Roland Underhill, Ryan Willson, Scott Chapman and Justus Leachman possess a combined investment experience of more than 100 years. "As partners, we don't hand the portfolio management off to juniors, because we don't have any juniors," says Underhill. "So, it's the quality, not the quantity of the people that matters."

The managers are responsible for monitoring portfolios and security positions on a day-to-day basis, managing cash reserves and proposing changes in portfolios. "One of our hallmarks is that we've only had three down years since 1974," says Willson. "We really try to focus on the preservation of capital for our clients."

MINDFUL METHODOLOGY

The team is clear on its objectives, not attempting to determine future events, but sticking to a solid investment philosophy that has been honed over time in order to find good stock ideas. "We're not economists — we take a fundamental, bottom-up approach here and try to put together a collection of much better than average companies that we then buy at a reasonable or bargain price," says Underhill. "We don't really know what the economy is going to do and we don't tell our clients that we do. We just don't invest that way."

"We actually have 25 separate criteria that we use to assess companies before we buy them," says Chapman. "And that's what we spend our time doing. If we find the right companies and buy them at the right price and they are led by above-average management teams, then the rest takes care of itself."

Thanks to modern technology and the efficiencies of research via the Internet, many of today's money managers build portfolios from behind their desks, although far too often the results prove to be less than stellar. LMA believes it is valuable to do field work — and makes a point of getting to know who's running the shows at the companies they invest in. But the due diligence doesn't just stop with the CEO or CFO — the team gets to know the companies' work environments, their employees, suppliers and competitors and then works to build these relationships over time. Chapman explains that in the last six to nine months LMA managers have gone out and personally visited with the management of every single one of the firm's top holdings; it has between 15 to 20 securities per portfolio.

When determining whether to add a company, the team looks for key components. First, the companies must be industry leaders, have proprietary products and/or special expertise in their respective industries or be one-of-a-kind companies. They also look for low debt/equity ratios, businesses in fields that have high barriers to entry with limited direct competition. They must also be low cost producers and work to maintain that advantage, as well as retaining pricing power. These companies must also have the ability to self-finance growth, have significant and sustainable competitive advantages, possess above average profitability in terms of operating margins and return on equity capital and finally, operate in open-end, growing markets.

Adhering to its rigorous criteria enables the team to weed out the best from the rest. The mediocre never make it to the final cut. "First of all, we like a company to meet two-thirds of our investment criteria," Willson says. "Step two involves the amount of due diligence that goes into a company once we've identified one that meets the criteria. We spend an incredible amount of time and place a lot of emphasis on these management teams. One of the things we are looking for is good leaders."

The third important element is the firm's pricing discipline. "Once the company has met the criteria and we like the management and their abilities, then it becomes a matter of valuing the company and setting our buy target. If we can buy these great companies with great management at a discount to their fair market value then the rest should really take care of itself in theory," says Willson. "That's not to say that we just close our eyes and let them run – it's an actively-managed portfolio. But our goal is to find those great companies and then let them ride. We only have a 15% to 20% turnover on an annual basis, so we really are buy and hold managers."

THE WAITING GAME

Timing continues to play an all-important role — and waiting isn't something that comes naturally for many investors, who tend to invest more emotionally rather than waiting for the right opportunities. "We want to buy good companies at a cheap price — that's the bottom line," says Lateef. "When one of our portfolio managers identifies a company he thinks is an attractive business, does his homework and presents it to the rest of us, we sit down and talk about it and try to determine at what point we should buy it. And I think this is one of the reasons why in bad markets we have done so well — because we have bought these companies really cheap, not trying to reach out for them when they were really high."

"Part of our success is not just the prices we pay, but the companies we buy," says Chapman. "If you look at our weighted average top 20 holdings, the earnings per share growth has been 19% for the last five years and that compares to barely mid-single digit growth for the S&P 500. We believe over the long term, there's a very high correlation between a stock price and behavior of a company and the earnings capability of that company. So finding companies with higher earnings growth relative to the market has helped our performance. Plus, we've bought them at a discount to what we think they're really worth and that's helped our performance stay positive as well."

WHEN TO SELL

Just as it's important to know when to buy, the LMA team has in place sell disciplines. Factors that contribute to a sale decision include major changes that may occur in industry fundamentals or a company's investment fundamentals have deteriorated due to things such as a change in management, competing products or a re-evaluation of corporate direction or outlook. Stocks sometimes become overvalued due to an overly optimistic outlook of the investment profile, which can discount earnings excessively into the future. By taking the time to discover good stock ideas, LMA manages to keep its turnover low and performance high. ✦

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