The Ralph Wanger Approach: Growth at a Reasonable Price

By Maria Crawford Scott

In the mutual fund manager horse race, Ralph Wanger thinks of himself as a horse of a different color—actually a zebra, to be more accurate, who must stand apart from the herd to find the choice pickings. And Mr. Wanger certainly has stood apart from the crowd, racking up an impressive track record as portfolio manager of the Acorn Fund, a fund that focuses on smaller-capitalization stocks.

Mr. Wanger has been a consistent promoter of small-stock investing, and has held to his investment philosophy through the best and worst market environments. Although there are numerous small-cap funds today, the Acorn fund is one of the oldest, having been launched by Mr. Wanger in 1970.

Mr. Wanger uses the zebra metaphor to argue his case for investing in smaller-capitalization stocks. It is difficult to find the green grass of opportunity among stocks that have been picked over by the heavy competition of other smart, full-time investors. He therefore prefers to stand apart from the herd, a stance most zebras won't take because of fear of becoming lion lunch, and a stance many investors won't take because of the greater risks.

His investment approach primarily focuses on finding the opportunities and limiting the risks of investing in smaller-capitalization stocks. It is outlined in his new book "A Zebra in Lion Country: Ralph Wanger's Investment Survival Guide," published by Simon & Schuster (800/223-2336), which is the primary source for this article. The book reflects Mr. Wanger's well-known wit and humor, which have made his Acorn Fund annual report commentaries entertaining; the book itself is highly readable.

Why Small-Cap Stocks: The Philosophy

Aside from offering less-exploited opportunities, Mr. Wanger points to several other advantages offered by investing in smaller-capitalization stocks, which he defines as companies below $1 billion in market capitalization (share price times number of shares outstanding).

First, smaller companies have more room to grow. No company can sustain a high growth rate forever, and eventually a firm's size starts to weigh it down. Large companies simply cannot sustain the high growth rates achievable by a fast-growing company.

In addition, Mr. Wanger likes to focus on long-term trends and change. He notes that change creates opportunities for investors who can perceive them and points out that smaller companies can adapt more readily to change. "Dumbo could fly because he was a baby elephant. Adult elephants are aerodynamically unsound," he states.

There are also more actions that can cause the prices of small-cap companies to rise. Stock prices will rise due to: earnings growth; acquisition by a larger company at an above-market price; stock repurchases by the company; and an increase in the price the market is willing to pay for one dollar of earnings due to increased institutional interest. Typically, though, large-company stock prices rise only for the first reason, while smaller companies will see prices rise for all of those reasons.

And, Mr. Wanger finds smaller companies that are in only one or two lines of business to be more easily understandable than large companies that are in many lines of business.

Lastly, Mr. Wanger points to numerous academic studies indicating that smaller-cap stocks have provided higher rates of return over long time periods, even after adjusting for the risk.

Nonetheless, Mr. Wanger does acknowledge that investing in small-cap stocks is a riskier strategy, particularly since misjudgments are bound to occur.

Risk reduction, in Mr. Wanger's view, is in the careful selection of specific stocks. To lower the risk of small-cap investing, he suggests investing in companies that are established, with managements that have proven their capabilities over time, that have a sound balance sheet and a strong position in their industry. For that reason, he suggests avoiding stocks that are

Maria Crawford Scott is editor of the AAII Journal.

start-ups, initial public offerings, and turnarounds. He also warns against overpaying for a stock. Lastly, for individual investors, a small-cap portfolio should have at least 12 stocks.

Growth Stocks: Trend-Spotting

Mr. Wanger seeks growth potential, and he does so first by determining broad areas for potential future growth. Thus, his approach starts with a top-down outlook: He first identifies general "themes"—strong social, economic, or technological trends that will last longer than one business cycle (at least five years or more). The advantage of focusing on long-term trends, he says, is that most other investors are focused more on shorter-term predictions of two years or less, and it is difficult to outguess the competition, particularly since most investors are privy to the same information. The other advantage of focusing on long-term trends is that you must be a long-term investor, which is particularly important in the smaller-cap area because of high trading costs.

What does Mr. Wanger mean by a trend or long-term theme? One example he points to is underdeveloped countries and their development. These countries have been and still are investing in telephone systems, a trend he says has been obvious for many years and which has already benefited many investors in companies such as Mexico's Telefonos de Mexico. He also notes that individuals in developing countries will have more discretionary spending—and will therefore be buying more discretionary items.

Other possible theme areas Mr. Wanger points to:

- Rebuilding of infrastructure in countries worldwide
- Expansion of communications and transportation networks worldwide
- Energy exploration of older marginal oil fields by smaller energy companies
- Outsourcing of services and jobs that require technological and skilled personnel
- Money management, particularly as public pension systems are privatized

Mr. Wanger says that to identify trends, you must "develop an observing mind-set," that can draw generalizations from many different particulars. He suggests that trends can best be spotted from reading and one's everyday general experience, including the work environment. And he notes that it is easy—and likely—that mistakes will be made, which is why diversification is important.

Once a trend has been spotted, Mr. Wanger selects companies that will benefit from these themes. That doesn't mean that the investment is directly in the theme itself, particularly if it is a strong technological trend. In fact, he points out that most companies that are directly involved in "trend-setting" are the ones that will least benefit from the trend. His best example is firms that are directly involved in technology, which is certainly the most obvious and strongest long-term trend today. Competition among technology firms is strong, and even though there are many "geniuses" running these companies, they are competing with other geniuses.

Instead, Mr. Wanger prefers to invest in companies that will benefit from the technological advance—the downstream users of technology, rather than the technology companies themselves. Examples include the banking industry, which has been transformed through the use of ATM machines, the credit card industry, and the database and data processing industries.

Of course, a trend-spotting approach dictates that you must learn to recognize when the trend is "played out"—it no longer offers growth potential. The signs that a trend is ending include: the stocks of firms in the area become too pricey, there are many new issues coming out, and marginal players are starting to enter the field.

While trend-spotting is Mr. Wanger's primary source for ideas, he also considers a company to be promising if it is not part of a theme but has a near-monopoly in a special market niche that is likely to last more than one business cycle. That, he says, is a theme in itself.

Criteria for Purchase

The hardest work, in Mr. Wanger's view, is the selection process. Selecting a company consists of understanding the company, its products, its industry position, its financials, and its management. Then, you must make a decision as to whether the market price for the stock fairly reflects the company's real value and its prospects.

Finding value is an important part of Mr. Wanger's approach—he believes in growth investing, but only at a reasonable price. However, to find value, you must have a different perspective than others in the marketplace, and you must bring that fresh perspective with you when analyzing a company.

Mr. Wanger's selection approach emphasizes three areas: growth potential, financial strength, and fundamental value.

The growth potential comes from a company's ability to exploit its long-term theme. Thus, Mr. Wanger looks for companies that have a good product, an expanding market, and the ability to efficiently manufacture and market its products. In addition, it should have a special niche, in an area of the market that is not easily entered by competitors. "Boring" stocks are more likely to fit this description than glamour stocks.

Mr. Wanger focuses considerable attention on management, seeking a team that is capable of fully exploiting the company's niche. However, Mr. Wanger notes that this is a qualitative judgment than cannot be made by looking at statistics. Instead, he prefers talking to competitors, suppliers, and management itself (which he acknowledges is difficult for individual investors to do on their own). The signs of good management include:

- The management team is small and has considerable knowledge of the industry.
- Its plans for the company's future are reasonable, but not inflexible, and the management is adaptable to changing market conditions.
- A large share of company stock is owned by the managers.

To reduce the risks of investing in smaller-capitalization stocks, Mr. Wanger seeks companies with financial strength. Usually, companies that have survived various economic environments

The Ralph Wanger Approach in Brief

Philosophy and style

Investment in companies in which there is a well-grounded expectation concerning the firm's growth prospects, and in which the stock can be bought at a reasonable price. The best area for finding stocks that meet these criteria is in the small-capitalization market, in companies with financial strength and market dominance.

Universe of stocks

Smaller-capitalization companies (less than $1 billion in market capitalization) that are seasoned; no start-ups or initial public offerings.

Criteria for initial consideration

Identify general "themes"—strong social, economic, or technological trends—that will last five years or longer, and select companies that will benefit from these themes. In addition, a company may be promising if it is not part of a theme, but has a near-monopoly in a special market niche.

Criteria for purchase

Companies must show evidence of: growth potential, financial strength, and fundamental value:

- Growth potential: Company should have a special niche and should be in an area of the market that is not easily entered by competitors. Company also should have a good management team capable of fully exploiting that niche. Management is judged by talking to competitors, suppliers and management itself. Signs of good management include: The management team is small, with considerable knowledge of the industry; it has reasonable plans for the future but is adaptable to changing markets; and it owns a large share of company stock.
- Financial strength: Low debt relative to its industry, adequate working capital and conservative accounting practices. For manufacturing or retail businesses, debt should be less than half of company's total capitalization. Balance sheet should be scrutinized for liabilities other than debt (for instance, pension liabilities) and additional "hidden" assets (for instance, goodwill or intangibles). Inventories and receivables relative to revenues should be examined for stability; rising ratios may indicate problems with sales and warrant further investigation. Companies that have weathered various economic environments tend to have financial strength; turnarounds, start-ups and initial public offerings are more shaky and therefore should be avoided.
- Fundamental value: Share price should be cheap relative to indications of earnings-growth prospects such as earnings, sales or cash flow; companies with recognized growth potential will have high multiples no matter which measure is used. Be wary of potential problems with each measure—for instance, price-earnings ratios can be misleading due to accounting manipulations of earnings. Operating profitability is best judged by cash flow (earnings before interest, taxes, depreciation, and amortization). Also, price should be cheap relative to company's asset value, which takes everything into consideration including long-term and short-term liabilities, as well as intangibles such as brands and patents; book value (assets less depreciation) is not a useful measure.

Valuation

To help judge value relative to growth potential, a valuation model is used, based on predicted earnings growth rate (not more than two years out), and a predicted price-earnings multiple (adjusted for the expected level of interest rates, since at high interest rate levels, multiples tend to be lower than when interest rates are at low levels). Model provides a price for stock two years hence, and thus an expected rate of return over two years; this is compared to what most analysts are expecting, and the stock is considered cheap if expectations are higher than consensus analyst expectations.

Stock monitoring and when to sell

Stocks should be held for the long-term, particularly given high trading costs associated with small caps. For adequate diversification, a small-cap portfolio should hold at least 12 stocks. However, an investor's total savings portfolio should not be invested only in small-cap stocks, but should consist of large-capitalization stocks and international stocks.

When purchasing a stock, the reason for the purchase should be written down. Stock should be sold when the reason for purchasing the stock is no longer valid—either it has acheived its expected potential, or it has failed. However, stocks should be continually re-evaluated. If the unexpected occurs, for instance, earnings come in lower than expected or other analysts' expectations are markedly different, re-evaluate management and its abilities; if original premise remains and the price has dropped, buy more, but if original premise turns out to be incorrect, sell. In general, let profits run.

have some form of financial strength, and for that reason he avoids start-ups, IPOs, and turnarounds.

He avoids companies with high levels of debt and where debt is rising, but notes that debt levels must be judged relative to other companies in the industry. For manufacturing or retail businesses, debt should be less than half of company's total capitalization. He also seeks companies with adequate working capital and firms that use conservative accounting practices.

Mr. Wanger also suggests examining other balance sheet items to make note of other liabilities (for instance, pension liabilities) and other "hidden" assets (goodwill and other intangibles and undervalued real estate) and to determine if the company is actually generating cash or if reported earnings are primarily due to an accounting function. Inventories and receivables should be examined relative to revenues to note any changes over time; rising ratios are a warning that inventories are building up.

The third leg of Mr. Wanger's approach is to seek fundamental value—the share price should be cheap relative to indications of earnings-growth prospects such as earnings, sales or cash flow, or relative to the asset value of the firm. He notes that companies that are recognized for their growth potential by the market will have high multiples no matter which measure is used. He finds advantages and disadvantages with each measure, and notes that investors who use the different measures should be wary of potential problems with each—for instance, price-earnings ratios can be misleading due to accounting manipulations of earnings. He suggests that operating profitability is best judged by using cash flow (which he defines as earnings before interest, taxes, depreciation, and amortization). And he says that the share price should be cheap relative to a company's asset value, which takes everything into consideration including long-term and short-term liabilities, as well as intangibles such as brands and patents.

Mr. Wanger's approach examines many different valuation measures, but he also uses a valuation model that helps judge a stock's value relative to its growth potential. The model is based on his own predicted earnings growth rate (not more than two years out) and a predicted price-earnings multiple that is adjusted for the expected level of interest rates (since at high interest rate levels, multiples tend to be lower than when interest rates are at low levels). The valuation model provides a price for stock two years hence, and thus an expected rate of return over two years. This is compared to what most analysts are expecting, and the stock is considered cheap if expectations are higher than consensus analyst expectations. Unfortunately, Mr. Wanger does not reveal his exact formula. [Interestingly, Benjamin Graham used a similar concept in his valuation model, which was discussed in "Value Investing: A Look at the Benjamin Graham Approach," May 1996 *AAII Journal*; the model appears on page 15 of that issue).

Monitoring and Selling Stocks

Mr. Wanger is a long-term investor, which is particularly important in the smaller-cap area because their illiquidity tends to drive up trading costs. Therefore, stocks should be purchased with the intent to hold for a long time period that is measured in years; if the stock performs as expected, liquidity will be less of a concern when it comes time to sell.

Mr. Wanger suggests that when a stock is purchased, the motivating reason for the purchase should be written down. Stocks should then be carefully monitored to make sure that the reason for purchasing the stock is still valid. That means continuously revising the expected earnings outlook for the firm. If the unexpected occurs—for instance, if earnings come in lower than expected or other analysts' expectations turn out to be markedly different from your own—a re-evaluation of the stock is in order to find out if you have made an error in judgment, or if you have missed important information. If the original premise remains valid and yet the price has dropped, Mr. Wanger views it as a buying opportunity.

Stocks should be sold when the reason for purchasing the stock is no longer valid—either it has achieved its expected potential, or it has failed. In general, however, Mr. Wanger prefers to let profits run to avoid the mistake of selling too soon.

Wanger in Summary

While Mr. Wanger makes a strong case for investing in smaller-capitalization stocks, he does not feel that these should be an investor's only holdings. Instead, he emphasizes the need to diversify holdings among larger-capitalization stocks. Aside from simply ensuring you get adequate performance at all times, he notes you are more likely to stick with a small-cap approach during lean times if other parts of your portfolio are doing well.

Mr. Wanger is also a strong proponent of international investing and, in fact, many of the growth opportunities Mr. Wanger seeks are international in nature. However, he points out that investing in foreign markets directly is very difficult for individual investors to accomplish and he suggests the mutual fund route for most investors who want to invest overseas.

Lastly, Mr. Wanger states that his own approach is not necessarily the only approach to successful investing. The most important aspect of investing, he says, is to stick with stocks that you really understand, and to stick with a disciplined approach that suits your needs and personality.

The accompanying table provides a brief summary of some of the key points in Ralph Wanger's approach.

Wanger summarizes his own philosophy:

"Maintain independence of thought and a healthy degree of skepticism, so you won't be drawn into the herd. Don't overpay, no matter how much you like a company. Invest in themes that will give a company a long-term franchise. Invest downstream from technology. Think and invest globally. Find stocks to own, not trade."