

# THE GLOBE AND MAIL

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## FUND WATCH

# Formula has a recipe for success

**Montreal manager's small-to mid-cap U.S. mutual fund outpaces most rivals over four decades**

BY ANDREW ALLENTUCK

**F**ormula Growth Ltd. of Montreal manages U.S. small- to mid-capitalization portfolios for institutional investors. Its mutual fund, Formula Growth Fund, is a success story best known to the approximately 800 investors who own its units.

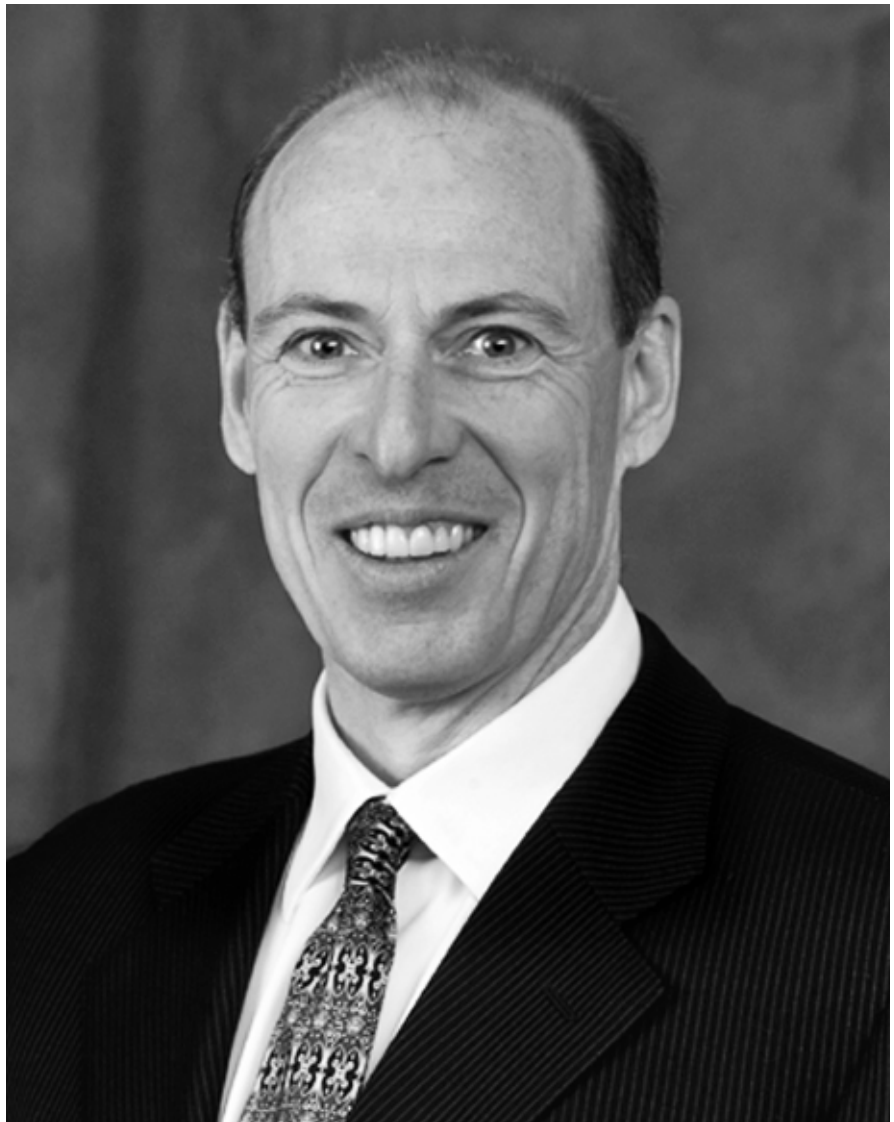
At the beginning of its 41-year history, \$10,000 invested in the fund would today be worth \$4,956,000 with all distributions reinvested, says Randy Kelly, Formula Growth president and manager of the \$460-million portfolio. That's the equivalent of a 16.3-per-cent rate of growth compounded annually. Investors must have a minimum of \$150,000 to get into the fund.

Says Stephen Jarislowsky, chairman and chief executive officer of Montreal-based financial advisory firm Jarislowsky Fraser Ltd.: "Anybody who can maintain that rate of growth for over 40 years has a super record."

The fund has survived four decades and beaten the averages for much of that period but, as Mr. Kelly acknowledges, it is difficult to compare Formula Growth with other U.S. small- to mid-cap portfolios.

"Our comparative results ought to be even better than they appear," he explains, noting that many competitors have not survived and so are not part of the average performance of U.S. small- to mid-caps.

There have been down periods, however. The fund declined 4.6 per cent for the 12 months ended June 30. It could



**Formula Growth president and manager Randy Kelly said discipline shielded the fund from the worst of the tech meltdown.**

have been a lot worse, Mr. Kelly says.

"We had 35 per cent of total fund assets in techs and telecoms in March, 2000, but our discipline kept us from the worst of the bubble."

He adds that the fund's senior staff share in the ups and downs of the portfolio.

"The fund managers and directors own 15 per cent of the units and we are

buying more," he says. "This is a place where we eat our own cooking."

It has been a good meal. For eight out of 10 years from 1991 to 2000, the fund did better than half of its peer U.S. small- to mid-cap funds. That is itself a result far better than what most fund managers do when competing with similar portfolios.

Behind the peer rankings is a stock

selection methodology that spreads risk among 150 stocks, many of which are in positions as small as 0.25 percent of total fund assets.

"These are our incubators for ideas. We increase investment in firms as our expectations are met or exceeded," Mr. Kelly says.

Stocks in the portfolio are picked on what are often called growth at a reasonable price criteria, Mr. Kelly says.

Prospects must offer 20 per cent earnings per share or cash flow growth per share for five years.

"We want to see a high degree of stock ownership by management. We'd expect that the CEO of a new company would have as much as 90 per cent of his net worth tied up in the firm," he says.

"We also want a strong balance sheet, a strong competitive position and a unique product or service or customer base. We try to avoid cyclical companies and we do have a bias toward service and technology firms."

Currently in the portfolio are:

• **Rent A Center Inc.** (RCII-Nasdaq), a Plano, Tex., firm that bankrolls home appliances and electronics on a rent-to-own basis. The firm's services appeal to transients such as oil workers who may not want to own goods or to persons who have maxed out their credit cards, Mr. Kelly says.

The firm, with 2,200 stores in the United States, generated sales of \$1.6-billion (U.S.) in 2000. It makes money on lending charges to customers who also pay conventional markups for goods.

"We went into this stock in 1995 at \$3.33 per share," he says. "Today, the stock sells for \$48.21, about 13½ times expected earnings per share of \$3.50 for 2002, and should go to \$60 within a year," he says.

• **AmeriCredit Corp.** (ACF-NYSE) is a Fort Worth, Tex.-based lender to U.S. auto dealers. "This firm buys loans from car dealers. Their specialty is credit-challenged customers to whom they charge up to 5 per cent more than banks," Mr. Kelly says. "The default rate on these loans is 2 to 3 per cent and where there are problems, the company repossesses the car and then may seek additional restitution from customers."

Currently priced at \$60 (U.S.), about 16 times expected earnings per share for 2002 of \$3.71, the stock should hit \$70 within 12 months, he says.

• **American International Group** (AIG-NYSE) is a life insurer and financial conglomerate based in New York that

Formula Growth bought in 1989 at \$1.27 (U.S.) a share. Over the past decade, the fund, which had an initial position of \$500,000, has realized gains in AIG of \$13-million, leaving \$6-million of the firm in the fund, Mr. Kelly says. Today, at \$82.28, the stock is priced at about 25 times expected 2002 earnings of \$3.30 and should go to \$100 within 18 months, he says.

• **Benchmark Electronics Inc.** (BHE-NYSE) is an Angleton, Tex.-based contract maker of electronic components that the fund bought in 1993 at a cost of \$7.80 (U.S.) when Mr. Kelly saw original equipment manufacturers outsourcing their assembly work.

"We found this small company competing with another of our stocks, Selectron Corp. We sold Selectron at a good profit, bought and kept this one," Mr. Kelly says.

"We figure this stock, currently priced at \$21.59, about 13½ times expected 2002 earnings of \$1.60, should rise to \$50 within two years."

• **Intercept Group Inc.** (ICPT-Nasdaq) is an Atlanta-based firm that sells computer software for electronic funds transfer services and debit cards to U.S. regional banks that could otherwise not compete with major U.S. banks. Mr. Kelly bought the stock in 1998 at \$7 (U.S.) a share when it looked like the stock would be a play on regional banks with state charters.

"We saw the market and that the company could grow. We saw the firm would be making acquisitions in related services such as cheque imaging. And we have made money." The stock, trading at \$35.26, about 33½ times expected earnings of \$1.05 a share for 2002, should rise to \$40 within two years, he says.

## Formula Growth Fund

**Category:** U.S. small-to mid-cap

**Manager:** Randy Kelly of Formula Growth Ltd.

**Load status:** None

**Total assets:** \$460-million

**Management expense ratio:** 1.09%

**Minimum investment:** \$150,000

**Globe five-star rating system:** \*\*\*

## Returns to June 30, 2001

**1-year simple rate of return:** -4.6%

**3-year compound annual return:** 6.6%

**5-year compound annual return:** 12.8%

**10-year compound annual return:** 22.9%

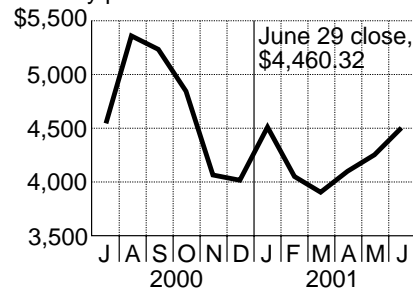
**20-year compound annual return:** 15.7%

**30-year compound annual return:** 16.1%

**40-year compound annual return:** 15.1%

## Net asset values

Monthly price



## Top 10 holdings to June 30

1. Rent A Center	4.8%
2. AmeriCredit	3.5
3. McKesson HBOC	2.3
4. American International Group	2.0
5. Valuevision International	1.9
6. Benchmark Electronics	1.8
7. Healthsouth	1.8
8. Cabletron Systems	1.7
9. Circuit City Stores	1.4
10. Sonic Automotive	1.3

Sources: Globe Hysales and company

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• **America Service Group** (ASGR-Nasdaq) is a Nashville-based company that operates more than 100 prisons in the United States. Purchased last summer at \$17 (U.S.), the stock is trading at \$18.94, about 8½ times expected 2002 earnings of \$2.25 a share.

"This small-cap manages the health care services within jails," Mr. Kelly says. "So this is a niche health maintenance organization with captive customers, literally. Big funds can't buy this stock in meaningful amounts, but we can."

The stock should rise to \$40 within 18 months, he says.

Mutual fund experts are impressed with the portfolio's performance.

Says Dan Hallett, senior analyst for Sterling Mutuals Inc., a Windsor, Ont., fund dealer: "This fund has beaten its benchmark more often than not in the last five years and when they beat the index, they beat it by a lot. And most of all, you can't argue with the record; over decades, they have produced very handsome returns."

Adds Scott Barlow, mutual fund analyst with Merrill Lynch in Toronto: "This is a tough space in the market to have long-term superior results, but this fund has done it. The coming year, which our firm predicts will see U.S. small-caps outperform large-caps, should be good for the fund."

*Special to The Globe and Mail*