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High Earnings per Share = High Internal Rate of Return (the Argument)

"I skate to where the puck is going to be, not where it has been."

—Wayne Gretzky

It would be convenient if, to pick tomorrow's winners, you just had to look at past results. Unfortunately, that plan doesn't work because the world is constantly changing.

If you were to look at the leading U.S. industries in 1925, you would find that 23 of the 100 largest capitalization companies were in the railroad industry. Ten were automobile companies, and four were in metals and mining. None of the 100 largest companies were in information technology, health care, or financial services.

Fast forward the clock to 2005. Only one metals and mining company was among the largest 100 companies, and no companies were in automobiles or railroads. Conversely, 20 information technology companies were among the 100 largest, as were 23 financial services companies and 17 health-care companies.

THE PAST ISN'T A PROLOGUE TO THE FUTURE

Number of Companies in the Top 100		
INDUSTRY	1925	2005
Railroads	23	0
Metals and mining	4	1
Autos and parts	10	0

NUMBER OF COMPANIES IN THE TOP 100

INDUSTRY	1925	2005
Information technology	0	20
Financial services	0	23
Health care/pharmaceuticals	0	17

Source: FactSet, Michael Milken.

While we know that we won't find the winners of tomorrow by reviewing the winners of the past, it's instructive to analyze the top-performing companies to learn what to look for when identifying the stars of tomorrow.

→ TOP-PERFORMING STOCKS, 1995–2005

To identify the all-stars in the stock market, I evaluated more than 10,000 companies to find the 25 top-performing stocks from 1995 to 2005 on a total return basis. Who made the list was interesting but not that educational—after all, any knowledgeable follower of the market could have picked these in hindsight. And since we know the past isn't a prologue for the future winners, what's noteworthy isn't who made it, but how they got there.

In order to place my convictions in perspective, I analyzed the top-performing companies' characteristics to highlight where growth companies come from and how they create value for shareholders. Notably, many of these companies exemplify the megatrends that prevailed during the study period—a fact that is far from coincidental.

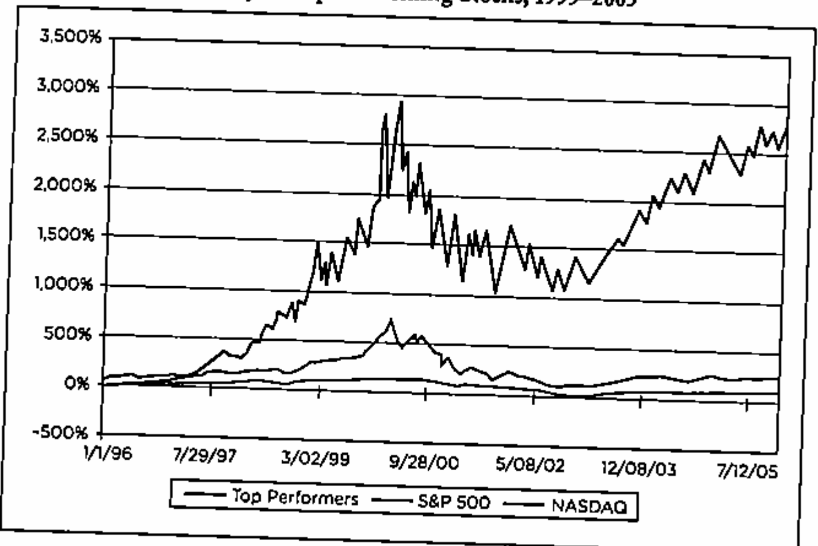
1995-2005 ALL-STARS

TICKER	COMPANY NAME	MARKET CAP ($ MILLIONS) 12/31 1995	MARKET CAP ($ MILLIONS) 12/31 2005	STOCK CAGR	EPS GROWTH	P/E 12/31 1995	P/E 12/31 2005
1 AEOS	American Eagle Outfitters	59	3,456	49%	62%	29.0x	12.2x
2 PENN	Penn National Gaming	56	2,734	41%	24%	11.3x	40.4x
3 CELG	Celgene	117	10,992	40%	226%	222.9x	186.2x
4 XTO	XTO Energy	326	15,964	40%	42%	15.7x	18.2x
5 DELL	Dell	3,220	72,097	39%	32%	13.7x	23.2x
6 JBL	Jabil Circuit	199	7,629	39%	31%	17.4x	30.6x
7 BBY	Best Buy	694	21,527	37%	30%	12.5x	21.6x
8 RMD	ResMed	93	2,733	37%	29%	21.4x	40.9x
9 WFMI	Whole Foods Market	256	10,633	36%	21%	24.1x	77.9x
10 EXPD	Expeditors International of Washington	314	7,346	35%	25%	18.9x	41.5x
11 OSK	Oshkosh Truck	129	3,308	33%	27%	12.7x	20.5x
12 URBN	Urban Outfitters	199	4,213	33%	25%	18.4x	35.1x
13 LM	Legg Mason	423	13,510	33%	23%	16.1x	33.9x
14 SNDK	SanDisk	330	11,472	33%	32%	34.7x	36.1x
15 QCOM	QUALCOMM	2,785	71,406	32%	43%	76.8x	34.1x
16 PNRA	Panera Bread	82	2,061	32%	48%	58.9x	41.2x
17 GLYT	Genlyte Group	86	1,525	32%	25%	11.0x	18.5x
18 MRX	Medicis Pharmaceutical	60	1,760	32%	27%	18.9x	26.9x
19 EV	Eaton Vance	263	3,559	32%	20%	9.8x	24.1x
20 ELX	Emulex	61	1,671	31%	51%	42.7x	24.0x
21 IMDC	Inamed	67	3,197	31%	15%	8.6x	46.8x
22 BRO	Brown & Brown	216	4,274	31%	22%	14.6x	29.3x
23 AMHC	American Healthyways	76	1,573	30%	20%	22.8x	51.0x
24 BIIB	Biogen Idec	294	15,030	30%	23%	36.1x	116.4x
25 USNA	USANA Health Sciences	71	765	30%	34%	27.3x	20.3x
	Mean	419	11,777	35%	38%	31.8x	42.0x
	Median	199	4,213	33%	27%	18.9x	33.9x

Source: FactSet, ThinkEquity Partners.

In the study, the average top 25 company had an initial market cap of $199 million in 1995, grew earnings 27% annually, and experienced an annual P/E multiple expansion of 6% to yield annual price appreciation of 33% through 2005. At the end of the 10 years, the average market capitalization of those same 25 companies had grown to $4.2 billion!

Study of Top-Performing Stocks, 1995–2005



Source: FactSet, ThinkEquity Partners.

As this concise study highlights, profits are fundamental to a growth stock's long-term performance. With a significant portion of the performance being contributed by P/E multiple expansion—despite relatively high multiples at the outset—the market affords a clear premium to companies that are able to consistently capitalize on their market's rapid growth.

This premium of P/E multiple expansion is what differentiates a growth company from a growth stock (i.e., a premium company earns a premium valuation). By comparison, companies that rely upon the broader economy to help them achieve long-term growth will find it far more difficult to achieve a premium valuation in the absence of a strengthening economy, decelerating inflation, and rising consumer and business sentiment.

Just to make sure that this 10-year period wasn't a fluke, we went back to the 10 years between 1985 and 1995 to examine the characteristics of the 25 top-performing stocks during this period.

Lo and behold, the medium market cap for the top-performing companies from 1985 to 1995 was even lower, $134 million. The median P/E was 17.6x and the average earnings growth was 31%. The class of '95 had an average stock price CAGR of 32%.

1985–95 ALL-STARS

		MARKET CAP ($ MILLIONS)				P/E	
TICKER	COMPANY NAME	12/31 1985	12/31 1995	STOCK CAGR	EPS GROWTH	12/31 1985	12/31 1995
1 AMGN	Amgen	147	15,776	49%	88%	14.1x	31.5x
2 HD	Home Depot	313	22,766	44%	39%	22.9x	32.6x
3 AMAT	Applied Materials	134	7,059	41%	40%	14.7x	15.4x
4 STJ	St. Jude Medical	98	3,437	38%	27%	8.8x	25.2x
5 MU	Micron Technology	163	8,202	37%	33%	2.7x	8.5x
6 MDT	Medtronic	657	12,980	35%	22%	12.8x	36.3x
7 PAYX	Paychex	108	2,273	35%	31%	36.6x	50.1x
8 PHS	Pacificare Health Systems	107	2,696	35%	30%	16.7x	23.1x
9 NKE	NIKE	528	9,973	35%	48%	51.9x	20.8x

TICKER	COMPANY NAME	MARKET CAP ($ MILLIONS) 12/31 1985	MARKET CAP ($ MILLIONS) 12/31 1995	STOCK CAGR	EPS GROWTH	P/E 12/31 1985	P/E 12/31 1995
10 IGT	International Game Technology	72	1,360	35%	51%	46.2x	14.8x
11 TLAB	Tellabs	156	3,286	34%	31%	22.5x	29.3x
12 DHR	Danaher	80	1,657	32%	31%	16.4x	18.0x
13 ADCT	ADC Telecom-munications	120	2,290	32%	20%	15.2x	39.1x
14 BMET	Biomet	112	2,063	31%	35%	31.8x	23.9x
15 FNM	Fannie Mae	1,886	33,818	31%	36%	18.0x	15.9x
16 CBRL	CBRL Group	51	1,039	30%	33%	20.2x	15.5x
17 RHI	Robert Half International	77	1,210	29%	21%	16.0x	30.9x
18 SYK	Stryker	180	2,549	29%	26%	21.7x	29.3x
19 SUP	Superior Industries International	60	766	29%	21%	7.6x	14.9x
20 BRK.A	Berkshire, Hathaway	2,833	38,327	29%	6%	6.5x	48.0x
21 OCR	Omnicare	75	1,178	28%	20%	25.6x	52.3x
22 NOVL	Novell	188	5,295	28%	43%	46.0x	15.8x
23 CD	Cendant	214	6,195	28%	25%	54.6x	69.8x
24 INTC	Intel	3,395	46,592	28%	37%	15.2x	14.2x
25 SFE	Safeguard Scientifics	58	727	28%	16%	17.6x	47.1x
	Mean	473	9,349	33%	32%	22.5x	28.9x
	Median	134	3,286	32%	31%	17.6x	25.2x

Source: FactSet, ThinkEquity Partners.

After considering the profiles of the top-performing companies, it is apparent that long-term stock performance is principally determined by earnings growth, not initial valuation, while the prevailing valuation is the result of historic operating success. The conclusion is that in the future investors seeking to identify the top-performing companies on these lists should not focus on bargain stocks or even "momentum" ideas, but rather identify growth companies that compete in large addressable markets and that possess dynamic long-term growth potential.

In addition, companies that operate in industries propelled by tailwinds will generally outperform the market. A tailwind occurs when a company and/or industry benefits from the trends that are shaping society. For example, companies that provide protection and screening services have received a tailwind from Homeland Security legislation. In contrast, a headwind occurs when negative trends are affecting an industry, such as nonsmoker-rights legislation creating a headwind for the tobacco industry. Those companies that are capable of successfully capitalizing on growing markets, rather than simply relying on the favorable tailwind, will capture larger market shares, be rewarded with premium valuations, and ultimately deliver the greatest shareholder value.

TOP 25 PERFORMERS

AVERAGE	PRICE TO EARNINGS		MARKET CAP ($ MILLIONS)		CAGR		P/E MULTIPLE CONTRIBUTION
	BEGIN	END	BEGIN	END	PRICE	EPS	
10-year study (1995-2005)	31.8x	42.0x	419	11,777	35%	38%	5%
10-year study (1985-95)	22.5x	28.9x	473	9,349	33%	32%	4%
MEDIAN	**PRICE TO EARNINGS**		**MARKET CAP ($ MILLIONS)**		**CAGR**		**P/E MULTIPLE CONTRIBUTION**
	BEGIN	END	BEGIN	END	PRICE	EPS	
10-year study (1995-2005)	18.9x	33.9x	199	4,213	33%	27%	6%
10-year study (1985-95)	17.6x	25.2x	134	3,286	32%	31%	3%

If we want to identify and invest in the companies that will appear on this list 10 years from now, here are my conclusions: (1) Focus on earnings growth, not the bargain basement. (2) Focus on small-cap stocks. Size forges an anchor to earnings growth!

Source: FactSet, ThinkEquity Partners.

→ PIGS AT THE TROUGH

"Even if you are on the right track, you'll get run over if you just sit there."

—WILL ROGERS

A key principle for successfully investing in emerging growth companies is to be very disciplined about limiting the number of companies you invest in. Knowing intimately what you own allows you to avoid some of the big blowups and stick with companies (or buy more of their stock!) even if they are hitting some bumps in the road.

Professors will tell you how important it is to diversify your portfolio—and if you want mediocre performance, they are correct. The fact of the matter is, to paraphrase Warren Buffett, we think it's better to have fewer eggs in your basket and watch them carefully.

Foster Friess, the highly successful investor who built Brandywine Funds, had a very simple analogy as a framework for how he added and subtracted stocks from his portfolio. He thought of his investments as "pigs at the trough."

I grew up in Minneapolis, which may bias my perspective somewhat, but picture going to the Minnesota State Fair on Labor Day weekend with rides on the Midway, carnival games, and everything one can imagine on a stick (pork chops, pickles, and even fried ice cream). Moving on, you go past the world's largest pumpkin, zucchini, and squash and now find yourself at the livestock exhibit.

After meandering through Rooster House, where it's so loud you can't hear yourself think, you come upon the relative tranquility of the Sow Barn, where you can see 1,300-pound pigs! There, at the trough, is a line filled to capacity with pigs eating things whose names are unprintable. At the end of the trough is a new little pig, but in order to eat, he needs to push aside the weakest pig to make room for himself.

What Foster said was that he was constantly looking at his portfolio "trough" and evaluating which was his weakest "pig" to replace with the up-and-coming one. If all the pigs at the trough were stronger than the new pig he was looking at, the lineup of pigs at the trough would be unchanged.

It's easy in this business to become comfortable with an existing

portfolio, but the fact is that things change. Whether it's relative or absolute valuations, fundamentals or a new company that has superior price appreciation potential, we're in a world of limited time and resources, so in order for something to be added, something else needs to be sold.

While small companies in general have proven to be excellent performers, the most attractive opportunities have been, and continue to be, found by focusing on growth.

While the performance statistics for leading growth companies are impressive, being able to identify which companies may top these lists in the next 5 or 10 years is of true value. In my view, these historical performance lists are a good starting point, not in selecting the companies on them today, but in leading us to identify what caused them to top the lists in the past.

→ THREE RULES OF GROWTH INVESTING: EARNINGS, EARNINGS, EARNINGS

Consistent with the results of my top-performer study, the long-term performance of a stock is nearly 100% correlated with a company's earnings. Underlying the 33% average annual price performance of the top 25 companies over the past 10 years was annual earnings growth of 27%. In the five years from 2000 to 2005, annual price appreciation of 50% was supported by earnings growth of 46%, while from 1995 to 2000, 75% annual price appreciation was driven by annual earnings growth of 53%.

What is also borne out in the study is that investors who are early to identify companies with sustainable long-term earnings growth receive a sizable benefit from P/E expansion—the quintessential "double play" of growth investing.

In the 10-year study, P/E contribution added an average of 6% to annual performance. Within that period, the P/E contribution added 20% to the average annual performance in the period from 1995 to 2000, and 10% in the period from 2000 to 2005, or more than twice the long-run average return of the S&P 500!

Notably, the companies identified in the study were not trading at "cheap" initial valuations, with an average starting P/E across all periods of 18.9x. Moreover, in the majority of instances, what likely was initially considered a "lofty" valuation expanded further. Even where valuation did contract from high levels, the sustained growth in earnings ultimately managed to more than offset the negative impact of valuation compression.

This highlights another important facet of the power of growth—great growth companies reduce valuation risk by growing the intrinsic value of their business relative to the potential value that investors have discounted.

→ THE GROWTH PROCESS

Investors seeking to identify the top-performing companies need a systematic means to identify growth companies that compete in large, addressable markets or nascent, rapidly growing markets, and that possess dynamic long-term earnings potential.

My research process is structured to accomplish the identification of large, open-ended growth opportunities as well as individual companies that possess the critical elements necessary to capture meaningful market share in these opportunities.

My top-down perspective focuses on megatrends, or the technological, economic, and social forces that develop from a groundswell, move into the mainstream, and disrupt the status quo. We believe that understanding today's megatrends provides us with a road map to where future market opportunities are developing.

My bottom-up analysis is centered on the four Ps—people, product, potential, and predictability—an objective framework to assess a company's potential to realize sustained long-term growth resulting from market megatrends.

→ EARNINGS DRIVE STOCK PRICE

"People may bet on the hourly wiggles in the market, but it's the earnings that waggle the wiggles long term."

—PETER LYNCH

At the foundation of my investment philosophy is the principle that over time, share price is nearly 100% correlated with earnings. Accordingly, we want to identify companies that are capable of achieving rapid and sustained earnings growth. This focus is not entirely in a vacuum, irrespective of factors such as current valuation. However, it is my belief that if I am right on the fundamentals that are predictive of rapid, sustained earnings growth, I will better position myself to be on the correct side of the valuation premium.

Rapid earnings growth dictates long-term performance of a company's share price, I believe, which leads us to focus on identifying the most rapidly growing and dynamic markets and, naturally, the companies participating in the growth of those markets or, better yet, driving it. As a corollary to my focus on growth, my search almost inevitably leads me to smaller companies, where even small incremental sales gains have a large impact on a company's overall growth rate.

Smaller companies are typically pure-play investments, with their products and services strategically focused on a particular market's growth. Large, established companies, on the other hand, are typically burdened with more mature businesses, and frequently operate in less related markets than those that smaller companies are focused on. The obvious result is that sales from a fast-growing product or service have a much greater impact on a small company that is squarely focused on a specific market.

It is just as important that a company is able to generate meaningful profits from rapidly rising sales, with a market-defensible position versus competitors. In one respect, small companies have a competitive advantage, with their ability to develop a market niche ahead of others, while their size and focus position them to remain nimble as the market continuously develops. Market focus and agility enable them to adapt more quickly and bring new products and services to market to meet customers' changing demands and preferences, while remaining ahead of larger, less nimble competitors.

In another respect, lack of size can be a competitive liability if a market niche remains underdeveloped or not well defined. This reality leads many small companies to realize subpar profit margins (leaving them inadequately positioned to finance future growth) and, more often than not, to fall behind the industry growth rate (i.e., experience declining market share)—the quintessential "me too" company.

GROWTH STOCKS VERSUS CYCLICAL STOCKS, 1995–2005

GROWTH STOCKS	CAGR		$1 INVESTED	
	EPS	PRICE	1995	2005
Wal-Mart	15%	15%	$1	$4.21
Microsoft	22%	17%	$1	$4.77
Dell	35%	39%	$1	$27.68
Starbucks	29%	28%	$1	$11.43
GROWTH BASKET	25%	25%	$1	$12.02
CYCLICALS	CAGR		$1 INVESTED	
	EPS	PRICE	1995	2005
General Motors	NM	−7%	$1	$0.47
JCPenney	−9%	2%	$1	$1.17
PG&E	−2%	3%	$1	$1.31
DuPont	−2%	2%	$1	$1.22
CYCLICAL BASKET	−4%	0%	$1	$1.04

Source: FactSet, ThinkEquity Partners.

Ultimately, to achieve rapid and sustained growth in earnings, a growth company must participate in a dynamic market, such as the information technology, health-care, alternative energy, consumer and business services, specialty retailing, or media and entertainment industries. The most successful of these growth companies are the ones that develop their own market niche and introduce proprietary products and services, with minimal competition, allowing them to achieve sustained, above-average industry profitability and ultimately create tremendous shareholder value.

Using historical examples to underscore my conviction that earnings growth drives stock price, I looked at several classic growth stocks and some more recent growth stocks and compared them to blue-chip cyclical stocks with respect to average annual earnings growth and stock price performance. The takeaway is that $1 invested in the portfolio of growth stocks 10 years ago would have grown to more than $12 today, but $1 invested in well-known cyclicals would have grown to just $1.70.

Why? Because the earnings for the growth stocks had increased at 25% during that 10-year period. On the flip side, the earnings for the four blue-chip but cyclical stocks had increased only 1% during that period.

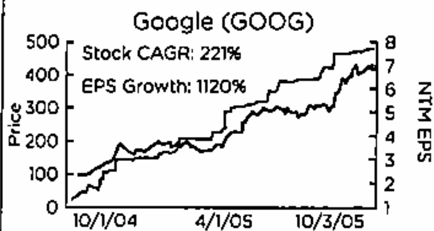
General Motors had net income of $1 billion in 1984. In 2005, it had net income of −$3.9 billion! It used to be said that as GM goes, so goes the nation. Thankfully, the correct reality is that as growth goes, so goes the United States.

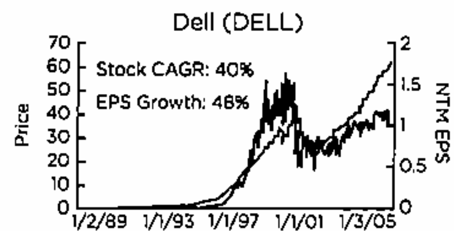
→ HIGH EPS GROWTH + BEATING EXPECTATIONS = MEGAWINNER

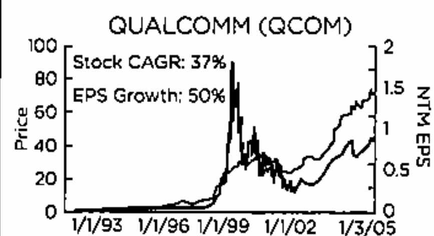
We now know that identifying companies that will achieve high earnings growth is the first step to bagging a winner (and over any meaningful period of time, all you need to do).

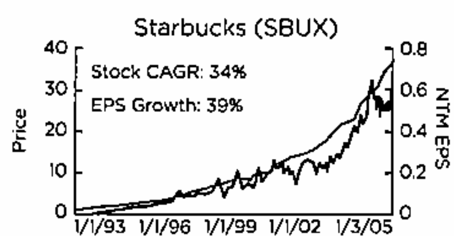
But to have an explosive stock—one that not only benefits from riding high earnings growth to new stock heights but becomes a megawinner—beating analysts' expectations consistently is a key ingredient to the formula.

Growth

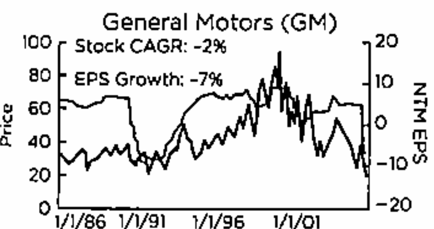


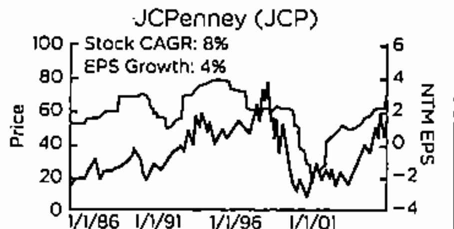


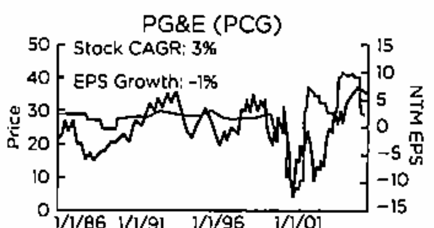


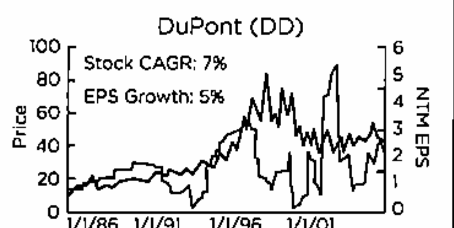


Cyclical









Price —— NTM EPS ——

Source: FactSet, ThinkEquity Partners.

Investors love positive surprises, but they hate negative ones. Accordingly, management teams that earn a reputation for "underpromising" and "overdelivering" are often rewarded with high P/E multiples.

For example, if analysts have forecast a company to achieve 20% earnings growth but it achieves 30% earnings growth, the stock will benefit not only from the high earnings growth, but also from the P/E revision that goes along with increased optimism for the company.

Nirvana for a growth stock investor is the combination of high earnings growth and beating expectations—the likely result is the double play of consistently high earnings growth and an expanding P/E multiple.

Here's the quick math of how this works: A company had earnings of $1.00 last year and was expected to have earnings of $1.20 this year, with analysts forecasting a three- to five-year growth rate of 20%. The investors valued the company's shares at 20x (20 times) P/E—or a P/E/G of 100%.

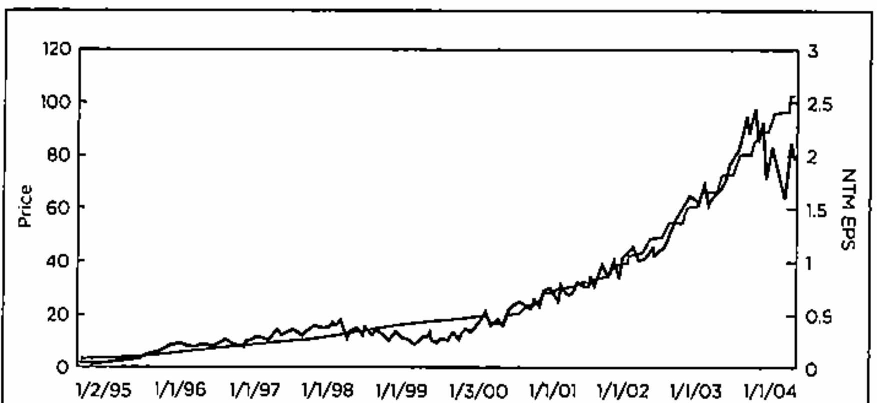
Fast forward the clock one year. The company actually delivered $1.30 earnings, so if investors just kept a 20x multiple on the shares, the stock would be $26 for a 30% return in that year. Instead, if investors began to believe the true growth rate was more likely to be 30%, valuing the company at 30x earnings would be reasonable. A normal-growth company in a normal market should be valued at a P/E of approximately 100% of its expected growth rate. This would result in the stock price being $39.00 or nearly doubling in 12 months.

THE DOUBLE PLAY: HIGH EPS GROWTH + BEATING EXPECTATIONS

	SHARE PRICE	CY EPS	ESTIMATED GROWTH	P/E	ACTUAL EPS	ADJUSTED P/E	PRICE	GROWTH
Scenario 1	$20	$1.00	20%	20x	$1.30	20x	$26	30%
Scenario 2	$20	$1.00	20%	20x	$1.30	30x	$39	95%

Apollo Group is a great case study. When Apollo went public in December 1994, it had a market value of $112 million and promised Wall Street 25% EPS growth. In actuality, Apollo Group achieved 42% EPS growth and met or exceeded Wall Street expectations for 45 quarters in a row. Not coincidentally, Apollo's share price compounded at 59% for that 10-year period.

Apollo Group (APOL)



- Apollo went public in Dec. '04 with $112 million market cap and promised Wall Street 25% long-term EPS growth.
- It actually delivered 42% EPS growth from 1995 to 2005.
- It had 45 consecutive quarters of meeting or beating Wall Street estimates.
- Not surprisingly, its stock CAGR is 48%.
- $1 invested in Apollo at IPO is worth $83 today!

Date	Actual	Estimates	Date	Actual	Estimates
Dec. '05	0.73	0.70	Dec. '00	0.14	0.09
Oct. '05	0.65	0.65	Oct. '00	0.12	0.12
Jun. '05	0.77	0.74	Jun. '00	0.12	0.11
Mar. '05	0.47	0.46	Mar. '00	0.07	0.07
Dec. '04	0.58	0.56	Dec. '99	0.10	0.09
Oct. '04	0.52	0.48	Oct. '99	0.09	0.09
Jun. '04	0.56	0.51	Jun. '99	0.11	0.11
Mar. '04	0.35	0.32	Mar. '99	0.06	0.06
Dec. '03	0.44	0.39	Dec. '98	0.08	0.08
Oct. '03	0.37	0.34	Oct. '98	0.07	0.07
Jun. '03	0.39	0.35	Jun. '98	0.09	0.08
Mar. '03	0.24	0.20	Mar. '98	0.04	0.04
Dec. '02	0.30	0.23	Dec. '97	0.06	0.06
Oct. '02	0.26	0.22	Oct. '97	0.05	0.05
Jun. '02	0.27	0.24	Jun. '97	0.07	0.06
Mar. '02	0.15	0.12	Mar. '97	0.03	0.02
Dec. '01	0.18	0.17	Dec. '96	0.04	0.04
Oct. '01	0.17	0.16	Oct. '96	0.04	0.03
Jun. '01	0.19	0.15	Jun. '96	0.04	0.04
Mar. '01	0.09	0.06	Mar. '96	0.01	0.01

Source: Company filings, FactSet, ThinkEquity Partners.

The objective is to find management teams that will underpromise and overdeliver in companies with high and sustainable earnings growth. This is where the biggest winners will be found. Apollo Group is the epitome of this objective.

STAR GAZER

JACK LAPORTE
portfolio manager for the New Horizons Fund at T. Rowe Price

Jack has been managing the $6.3 billion New Horizons Fund since 1987. The New Horizons Fund is one of the largest and most respected small-cap funds in the world. In his reign, Laporte has delivered an 11.8% yearly return, which is 1.6 points better than the S&P 500 and 5.5 points better than the Russell 2000 Growth Index. When I sat down with Jack, I asked him about some common mistakes that growth investors make. (To read my full interview with Jack Laporte, visit www.findingthenextstarbucks.com.)

Often growth investors are not willing to pay what they should for a truly unique, outstanding growth company. If you have a high degree of confidence that a company can grow their earnings at 20% a year for an extended period of time, you should be willing to pay a very high P/E on current earnings. Sometimes I fall into the trap of saying, "Ah, this is a great company with a great management, but it's too expensive." Well, if it really is a great company with great management, you should want to look through the current price (which might seem a little bit expensive based on current earnings) and realize that if you're buying it on the basis of earnings out two or three years, it's actually very cheap.

THINK POINTS

- Diversification increases the risk of mediocre performance.
- Following conventional wisdom is another sure way to miss the big winners.
- Don't drive on the highway looking through the rearview mirror.
- The stars of tomorrow generally are microcap in size, have a relatively high P/E, and have high earnings growth over a sustained period.
- High EPS growth and beating Wall Street expectations is the formula for megawinners.

4

Formula for Identifying and Evaluating the Stars of Tomorrow (the Process)

"Here's something to think about: How come you never see a headline like 'Psychic Wins Lottery'?"

—JAY LENO

ONE OF THE MOST BIZARRE REALITIES of Wall Street is the generally random process security analysts use to evaluate investment opportunities. I was an analyst at Lehman Brothers when it had the number-one-ranked research department on Wall Street. I was director of global growth research at Merrill Lynch when it was ranked number one. I was director of growth research and strategy at Montgomery Securities when that firm did better research than the other two top-ranked firms. And at all three places, the instructions were essentially the same: "Here's a laptop. This is your industry. Go write research and recommend companies."

Was there a Merrill Lynch way? A Lehman Brothers way? Or was there a process to identify, analyze, and recommend stocks? Absolutely not. Basically the "process" for doing security analysis was to hire bright, ambitious people and tell them to do their thing. Sometimes it works. And often it doesn't. It's not a mystery that research analysts are held in such low regard. The way Merrill Lynch and Lehman Brothers have established themselves as world-class firms has nothing to do with their approach to identifying the stars of tomorrow.

But it's not their fault because they haven't been given a process. If Starbucks hired kids off the street and told them, "Go make a latte," very few people would have ever heard of Starbucks.

One of the characteristics of great companies is that they are *systematic and strategic* in how they operate their business. Similarly, if you want to be a great investor, you need to be systematic and strategic in how you analyze companies.

We have created a "recipe book" on how to identify and invest in the fastest-growing companies in the world. It starts with our Think 10 Commandments and then proceeds to our megatrend analysis, our evaluation of a company's four Ps, and a disciplined valuation approach. How is this integrated in my process to identify the stars of tomorrow today?

→ THE THINKEQUITY PROCESS FOR IDENTIFYING AND INVESTING IN THE STARS OF TOMORROW

The ThinkEquity Partners' 10 Commandments are embedded in ThinkEquity's investment process. It's through these simple principles that investors will create the foundation to enhance their investment returns. Obviously, an investor's objective is to make money, but without a method, there is madness!

First, *be right on the fundamentals.* Earnings growth drives stock price. There is essentially a 100% correlation between how a company does and how its stock performs over time. Focus on the fastest-growing companies.

Second, *be proactive, not reactive.* Looking ahead and anticipating where the world is heading is how we catch winners early on. Try to predict what will be in tomorrow's newspapers, as opposed to reacting to what is in today's.

Third, *be rigorous, but don't have rigor mortis.* Looking at the balance sheet to make sure a company has enough cash to support your "blink" decision is important, but it is possible to overanalyze opportunities. The best investments are often easy and intuitive.

Fourth, *when wrong, admit it.* The best investors and analysts are wrong a lot. The worst thing to do is rationalize a mistake. Be intellectually honest. Make decisions based on current facts, not what you had thought to begin with.