

**ticker**<sup>®</sup>

Fund Insights

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# intro

Over the past two decades, mutual funds have become the preferred investment vehicles for most investment advisors.

Offering a wide variety of objectives, management styles, and risks, mutual funds provide the building blocks that advisors need to develop appropriate investment strategies for their clients. A mutual fund offers the advantage of a professionally managed, diversified portfolio of securities that an advisor can treat as a single investment instrument; but rather than having to analyze specific stocks or bonds, the advisor then faces the daunting task of selecting from among thousands of mutual funds.

In evaluating a mutual fund, the financial advisor can only look at how the fund has preformed in the past relative to its stated objectives and under various economic conditions. Rarely does an advisor have the opportunity to talk directly with fund managers in order to gain a better understanding about how they approach investment decisions, view specific opportunities, or react to different market environments.

Ticker Q&As are specifically designed to provide the investment professional an additional resource for evaluating funds. Ticker's in-depth interviews of fund managers, which are based on consistent precepts of investment style, risk management, and research practices, probe the strengths and weaknesses underlying the fund's performance and provide the information in a concise, easy to understand format. By gaining an understanding of a manager's core beliefs and investment process, an advisor can reach an informed judgment about the appropriateness of a specific fund for his client.

Ticker's staff selects more than one hundred funds each year that represent the broad cross section of fund families, categories, and management styles. We specifically search for funds that have distinguished themselves by generating consistent, above-average performance during varying market conditions. In addition, we look for funds whose performance may have deviated substantially from their past trends. Ticker receives no compensation from the fund management or fund families for the interviews and makes every effort to provide an unbiased and unvarnished synopsis of the portfolio manager's views.

Each fund manager has a unique and compelling story to tell and they are usually anxious to share their experience with the investing public. Whether they are a large-cap, deep value equity, or a corporate bond manager, they all have developed unique approaches to managing money. Ticker delves into a manager's core investment beliefs and guiding principles to determine and convey to readers how that philosophy translates into an investment strategy. We focus on the investment process, and specifically on the fund's research methodology and approach to risk management.

Based on our interviews, Ticker has identified a number of consistent characteristics among the better performing funds. For example, maturity and experience play an integral role in long-term performance. Managers focused on long-term returns seem to have a greater appreciation for business cycle risk and the knowledge that the investments you avoid often matters just as much as the ones you select for your portfolio. It is only by having an opportunity to talk directly to the fund manager that many of these insights can be uncovered.



# Gains in Relative Values

*The American Century Value Fund seeks long-term capital growth by investing primarily in companies with sustainable earnings through business cycles, leading market share positions and solid return on capital. The portfolio manager, Michael Liss, believes in using a bottom up approach and building a portfolio with stocks that offer the best risk rewards.*

## **What is your investment philosophy?**

We are looking for companies with sustainable earnings, leading market share positions and solid returns on capital. We pay a lot of attention to the valuation we pay for these companies. We want companies that have good balance sheets and are out of favor for what we determine to be transitory reasons. We are a long only fund and do not time the market.

## **What is your investment process?**

We have five main valuation screens and we are running the universe of domestic stocks through those screens to identify the cheapest third of the market. Once we have identified the valuation cutoffs for the bottom third of the domestic stock universe, we further narrow our investment universe to those stocks that meet at least two of our five valuation screens. After determining which stocks meet at least two screens, we begin our fundamental research to determine the leading companies that have the best returns on capital, the leading market shares, a solid balance sheet and are trading at a discount to their fair value. We are using a bottom up approach and are building the portfolio to include the stocks that have the best risk reward. Based on our fundamental work, we also have risk control measures to ensure that we have diversification across sectors and securities.

We build the portfolio by adding stocks offering good risk rewards. As the valuation of a stock declines and the risk reward becomes more favorable, we add weight to those stocks. As the risk reward deteriorates, we sell into strength of the stock. Once the stock no longer meets at least two screens we sell that stock and look for better risk rewards.

## **What is the value that you are seeking?**

We are not looking for deep or distressed value. We are looking at valuation relative to the current market and we use the history of where a stock has traded over time as a guide.

We employ our five valuation screens and we rely heavily on firm value to Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). Other screens we use are price to earnings, price-to-book, price-to-cash flow and dividend yield. A stock must meet the valuation cutoffs for the bottom third of the stock universe for at least two of those five screens in order to be included in the portfolio.

In addition, I have to measure how the stock looks relative to my other options. We have a list of about 300 companies. I have to look at the risk reward of those 300



**MICHAEL LISS** is a vice president and portfolio manager for American Century Investments®, a premier investment manager headquartered in Kansas City, Missouri.

Liss joined American Century Investments in 1998 and has worked in the financial industry since 1991. Previously, he was an investment intern with the Indiana University Foundation.

Liss holds a bachelor's degree in accounting and business administration-finance from Albright College in Reading, Pennsylvania. He earned his master's degree in finance from Indiana University. Liss is a CFA charterholder and a Certified Public Accountant.

**“We look for the companies that we think have the best risk reward ratios.”**

companies, one relative to the other. If Stock A offers upside of 20% and downside of 10% and Stock B offers upside of 10% and downside of 20%, I'm going to be more interested in Stock A because it is a better risk reward relative to Stock B..

**What is your definition of market? Do you limit it among peers or you define it by the S&P 500 index?**

I would make it even broader than that, Wilshire 5000. Even beyond that, you have anything out there that's traded domestically. We are constantly updating our screening techniques of where the market is, where the bottom third of the market is on our five main valuation screen tools. That's our starting point.

**Once it meets at least two screening criteria, what do you do next?**

We start to do the fundamental work. We want to figure out which companies are the leading companies within their industries, have the best returns on the capital, balance sheet, and sustainable leading market shares.

So, let me illustrate with an example of Kimberly Clark. We have done very well with the company over time. We discovered they had good returns on capital within consumer staples but with some room to improve their returns on capital. They generate lot of cash flow and have leading market shares in many product categories which have been sustainable over a long period of time.

Private label makers can undercut them on price but they have the innovation advantage and as long as they continue to innovate over time, they will be able to keep that price premium to private label in most of their categories. This has been a name that we have gone to and come back to as it drifts in and out of our valuation universe in the bottom third of the market on at least two of our five valuation screens.

**Can you give us a couple of examples of the stocks that don't meet your criteria?**

We haven't been able to buy Apple or Qualcomm on Valuations. Qualcomm is a good company that generates high returns on capital. They have leading share in a chip for mobile communication but it's been too expensive for us. Church & Dwight is another example of a good consumer products company that generates good return on capital and has a leading share in their consumer product niches but their valuations don't fit into our requirements.

**The bottom third of the market valuation is an important screen but when markets sometimes go down, as has happened in the last 18 months, the bottom third can also go down. What do you do to protect against the market swings and sentiments?**

We are not market timers. We don't have the ability to move our money into cash; we can't protect against down cycles. We are a long-only fund but we have to continue to look for the best risk rewards.

Our benchmark is the Russell 3000 value index, and it was down 36% in 2008 and the fund was down 26%.

We look for the companies that we think have the best risk reward ratios. That protected us somewhat on the downside relative to other funds and relative to the index. As an example, with the financials in 2008, we decided many of these companies had moved from being leading companies with stable returns on capital

to still being leading companies but unstable returns on capital. They went from being solid to speculative investments, like Citigroup, or Bank of America, or Freddie Mac and Fannie Mae. We decided after doing an analysis that their capital bases were too thin and it was a tossup whether some of these companies would survive the current financial crisis.

The way we protect our shareholders is by continuing to challenge our assumptions, making sure that we have the correct risk rewards framework. When I say the correct risk reward, I mean the fair value of the stock and the downside risk. The way we managed to avoid some of the stocks that went below a dollar, the AIGs and Freddie and Fannies of the world, was by focusing on where we thought the downside of the stock could be.

I can't emphasize enough how important our work on the downside is. It is just as important as our work on the upside. That's an important component of how we control risk and protect our shareholders.

### How many holdings do you have and what benchmarks do you look at?

We want a diversified portfolio. Within any sector of the Russell 3000 value, we can be plus or minus 1000 basis points. It gives us good leeway to move our positions one way or the other if we feel strongly about something but it also forces us to have diversification.

We do it on a bottom up basis. The best risk rewards will be the stocks that will have the highest weightings. If that risk reward approaches zero we will move away from those stocks. Holdings in the fund fluctuate anywhere between 80 and 120 names and we usually have 25% to 35% of the fund in our top 10 holdings.

### What are your risk controls?

One way we control risk is by buying stocks that fall in the bottom third of valuation and selecting companies that have higher risk reward ratios.

Another way we control risk is through weighting. We may feel certain names are more volatile than others and will build into our assumptions a much wider range of outcomes. Those stocks that have wide risk rewards or a wider range of outcomes are going to have lower weightings.

Kimberly Clark has had very stable returns on capital. On a relative spectrum, they don't have a big range of outcomes. Semi conductor equipment makers, like Applied Material or KLA-Tencor, are companies that we have done fairly well with over time. We have owned them at various points in the semiconductor industry cycle. The range of outcomes on those, although they have high returns on capital, also have a wider range of returns on capital over time. If you take the time to look back 10, 15, 20 years they have had high peak returns on capital, but those cycles were short. That's not something we are inclined to hold as bigger weightings as we would relative to something like Kimberly Clark.

We want a diversified portfolio. On a more macro level, we are within 1000 basis points of each sector weight in the Russell 3000 value. On an individual security basis, 500 basis points of active risk is within our guidelines.

## American Century Value Fund

Symbol	<b>TWADX</b>
Website	<a href="http://www.americancentury.com">www.americancentury.com</a>
Address	American Century Investment Management Inc 4500 Main Street Kansas City, MO 64111
Telephone	800-345-2021
Inception	10/2/1996

PORTFOLIO	
Total Net Assets *	\$90.6
Avg Mkt Cap (\$ Weighted) *	\$63,000
Average Price/Earnings Ratio	14.07x
Average Price/Book Ratio	2.21x
Turnover Ratio	152%

INVESTMENT INFORMATION	
New Investment	Open
Min Initial Investment	\$2,500
Min Subsequent Investment	\$50
Min Initial IRA Investment	\$0.00

RISK (AGAINST S&P 500 DAILY REINV IX - 3 YEARS)	
Alpha	-0.03
Beta	0.86
R-Squared	0.88
Ann Std Deviation	16.98
Sharpe Ratio	-0.68

RETURNS VS. S&P 500 DAILY REINV INDEX		
	TWADX	Index
1 Year (Cum.)	-28.99%	-35.31%
3 Year (Ann.)	-9.70%	-10.76%
5 Year (Ann.)	-2.19%	-2.70%

RETURNS VS. RUSSELL 3000 VALUE INDEX		
	TWADX	Index
1 Year (Cum.)	-28.99%	-38.61%
3 Year (Ann.)	-9.70%	-13.25%
5 Year (Ann.)	-2.19%	-2.42%

FEES AND EXPENSES	
Max Sales Charge - Front	5.75%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee	0.00%
Total Expense Ratio	1.25%


PORTFOLIO MANAGER	
Michael Liss	1998

\*millions  
04/30/2009; Source: Company Documents; Lipper

**In case of having enterprise value, do you adjust the value for the debt or are there other things you adjust as well?**

Yes, besides the debt we are looking at capitalizing operating leases because these are essentially like debt. It is off balance sheet debt. We want to bring that on the balance sheet so we can look at companies more on an apple-to-apple basis. If there are any pension liabilities outstanding, we try to factor in what cash the companies are going to need over the next few years. Then, we count that as debt because those are real payments. There are other adjustments we make, but these are two of the most common.

**When you look at price-to-earnings multiples, are you looking at historical or forward-looking multiples?**

We are going to look at both. P/E is a good tool but we feel it has some limitations relative to enterprise value to EBITDA. I think with that measure we can put companies on a level playing field. It adjusts for debt where as P/E does not. 

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*The interview was originally published on Ticker.com and 123Jump.com on 06/24/2009. For up-to-date information on the fund's performance, portfolio data, fees and expenses, please visit [www.americancentury.com](http://www.americancentury.com)*



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