

# Three of a kind

Martin Steward finds three managers exploiting three major investment themes in three different ways

## Strategy Review

Global growth stocks have struggled to maintain their lead over value since the 2009-10 market rally hit the buffers and with the IMF lowering its global growth forecasts that trend seems set to last. It is therefore impressive to find a growth strategy sitting on top of the Mercer global equity universe for the three years to the end of Q2 2012, let alone two more following close behind.

So how 'growthy' are these growth strategies? They are stuffed with IT stocks, very low on financials, and pretty much devoid of telecoms and utilities. Earnings growth and return on capital have been double those of their benchmarks.

And yet they trade at fairly modest valuations – Sands Capital Management's Global Growth portfolio is valued at 18 times forward earnings, Artisan Partners' Global Opportunities 19 times and Calamos Investments' Global Growth just 15 times – despite the ring of 'quality' at the heart of all three: debt-to-capital ratios are less than half the broad market's, with Calamos weighing in at an exceptionally light 13.6%.

"We're in this phase of the market where we are able to find good growth companies with very strong financials," says CEO and CIO John Calamos. "That's not always the case. Apple, 20 years ago, needed to raise capital to bring out a new product."

### 'Seasoned leaders'

This is important. Apple is a very different company from the one that was operating in the 1990s. It has its own spending money but can still grow like an adolescent because that money is generated from intellectual capital, which provides a wider, deeper 'moat' around its market position than any physical capital could. Sands Capital calls these 'seasoned leaders', and the IT sector is where they dominate.

"Particularly in the tech sector, you tend to get 'winner-takes-most' business models," says senior portfolio manager Sunil Thakor puts it. "Gigantic but very innovative companies that sell products and services globally."

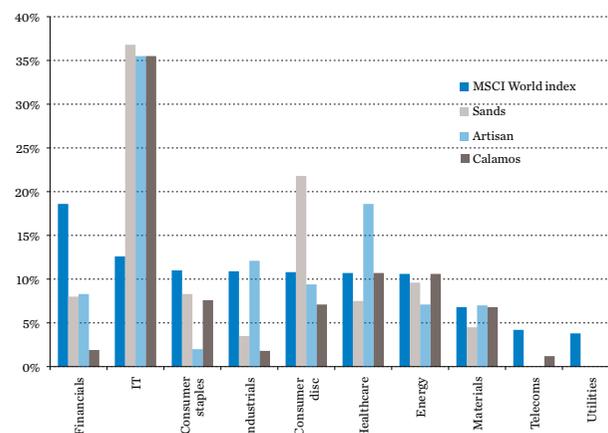
Sands Capital thinks in terms of 'choke points' in value chains, where a couple of companies dominate. Most industries have one or two, but in IT, and particularly mobile devices, it is not unusual to find three or more.

"While every single phone has a chip, all of those chips are based on ARM technology," says senior portfolio manager David Levanson. "While multiple companies make the equipment required to make semiconductor chips, only ASML makes the equipment for the photolithography step. And while every phone connects to a cellular network, that connection is always based on Qualcomm technology. Qualcomm and ARM

effectively have royalties on the growth of the mobile devices market."

It is not surprising, then, to find all three managers more-or-less focused on mid-stage growth companies – old enough to have dug a moat, young enough still to grow. They are not all in agreement: Artisan has a more explicit policy for including early-stage growth in what it calls its 'Garden' portfolio (established growth

### I. Sector weightings



Sources: Sands Capital management; Artisan Partners; Calamos Investment; MSCI

goes into its 'Crop' portfolio, while its 'Harvest' portfolio is stocks being trimmed because they have hit their growth plateau or become overvalued). This goes some way to explaining its high, 75%-plus annual turnover. It is also much more sceptical about Apple's continued growth than either Sands Capital or Calamos, for example (it made it a 'Harvest' position over a year ago and has been trimming it ever since). But overall, 'seasoned leaders' with 'quality' and 'moats' are a discernible theme.

Which is not to say that prevents them from behaving like growth portfolios. As the Mercer table reveals, all three had a rough time of things during Q2 of 2012.

### High beta

Artisan fared best, but that was largely thanks to its overweight in the US. Among its larger positions, National Oilwell Varco, Hexagon, EMC and Baidu underperformed. To take one example, Hexagon, a global leader in precision design and

measurement tools, is a high-beta stock thanks to considerable exposure to China's infrastructure spend, but also because it is three-quarters owned by very sticky Swedish money.

The story of high-beta stocks in 'wide-moated' positions can be traced through the other portfolios, too. For Calamos it is about a sector exposure.

"The cyclical areas are exactly where we suffered relative to the benchmark in Q2," says Kristina Kalebich, a senior portfolio specialist at Calamos. "The metals-and-mining sector is one area that hurt the portfolio over the last year."

For Sands Capital it's more about a regional exposure: an overweight in emerging markets, specifically Latin America, was down 7-8% during Q2. But these are hardly risky businesses: they include Walmart de México, MercadoLivre (eBay's partner in Brazil), BM&F Bovespa, Cetip and Cielo.

Brazil's unusual financial market oversight rules have enabled Cetip to evolve a uniquely powerful securities-repository business model that combines elements of a clearing house, a deposit trust company and an exchange; and whereas the merchants acquiring business is very competitive in every other jurisdiction in the world, in Brazil Cielo and Redecard control the market. Similarly, Brazil's regulatory infrastructure allows BM&F Bovespa a monopoly on derivatives and cash equities trading, a foundation for its 85% share of trading volume across Latin America. "You can find that type of market structure or that kind of growth elsewhere – but not both combined," says Thakor. They are volatile stocks, to be sure: "But to my mind, there can be a big difference between defensive companies and defensive stocks."

### Unloved

It is the recent volatility that has made genuinely growthy names trade with value-like P/Es. All three managers are focused on some variation of private market 'intrinsic value', which they expect to sit at a 20-40% premium to public-market valuations. But they also think growth is being significantly undervalued at the moment, and that investment for growth is particularly unloved by the market.

Hamel at Artisan recently visited Rakuten in Japan – a cross between Amazon and eBay with a dominant domestic position delivering 55% EBITDA margins. It is currently spending its free cash on assaults on a range of overseas markets. "Because of that, the profitability has been temporarily camouflaged as they take losses in these new markets," he says. "The stock price has come under pressure as a result. That's an interesting situation for us: they have an iconic brand at home, and the question is whether they can take that and develop the same model in these new regions."

He cites EMC Corp in the US, too, which has been busy building its cloud-computing offering since the acquisition of VMware back in 2004, but still trades at just 15 times earnings and was one of Artisan's worst performers during Q2 2012.

Our managers see this as a buying opportunity. During the good times, Levanson says that his companies maintain that two-times benchmark earnings growth, whereas during the tough times the gap gets even wider. "If our company can build new stores, warehouses or products while second-tier companies are crippled by highly-levered balance sheets, that opens a very substantial earnings growth differential in tough times," he reasons.

The challenge of what to buy when growth expectations are so modest is reflected in the three master themes common to these portfolios,

## Under review

Name of strategy	Inception date	Portfolio manager(s)	Key positions
Sands Capital Global Growth	January 2009	David Levanson and Sunil Thakor	Overweight emerging markets; consumer discretionary stocks; and IT stocks. Underweight financials.
Artisan Opportunistic Growth	February 2007	James Hamel, Andrew Stephens, Craigh Cepukenas and team	Overweight US; IT stocks; and healthcare stocks. Underweight financials.
Calamos Global Growth	January 2007	John Calamos, Gary Black and team	Overweight Europe; IT stocks; and materials stocks. Underweight financials. Exceptionally low portfolio debt-to-capital ratio.

each designed to seek out growth in a low-growth world: money-saving and productivity-enhancing technologies; the digitalisation and mobilisation of the consumer; and consumption in the emerging world.

## Productivity enhancement

Money-saving is a priority in both the public and private sectors, and the fastest-growing expenditure in the public sector is healthcare.

Prevention is better than cure, as the saying goes, and Artisan picks out molecular diagnostics leader Cepheid as helping healthcare providers to “more efficiently and cost-effectively treat patients”.

Both Sands Capital and Artisan agree that biotech – where products and technologies are less commoditised – is the most interesting place to be in healthcare. Sands Capital picks out Alergan and Biomarin; Artisan goes for Biogen Idec and Regeneron Pharmaceuticals. The latter got FDA approval a year ago for its drug Eylea, a treatment for diabetic macular oedema. It has already taken a 15% share of a \$5bn market from Lucentis and Avastin, and Hamel expects it to take 50% because it cuts the need for invasive eye injections by half – which is better for patients but also slightly cheaper. It also has a great business model, keeping 45% of profits even as its R&D is 100%-funded by Sanofi (a 19% shareholder).

Calamos cites Intuitive Surgical, whose minimally invasive robotic surgery equipment drastically cuts patient recovery times. “That benefits the patient, it enhances productivity in the hospital and it presents potential cost savings for the medical system generally,” Niziolek observes.

Sands Capital, underweight healthcare in part because it recognises cost pressures on commoditised treatments, nevertheless finds “some absolute gems”, as Levanson puts it, including IT and systems business Cerner Corp. “There’s new emphasis on paying for quality, paying for performance, reducing medical errors, but to measure all of that you need integrated IT systems through hospitals and indeed the entire healthcare system, which is where Cerner is a leader,” he says.

For the private sector, Niziolek could be speaking for all three managers when he says that a “key theme” behind many holdings in IT “is productivity-enhancement”. Just as healthcare is turning to the likes of Cerner to enhance its use of data, several industries are exploring better ways to store and analyse their ‘big data’. “We have a lot of companies benefiting from that trend, from larger companies like SAP that have a segment of their growth coming from that, or smaller companies like Mellanox Technologies that are highly-levered to it,” says Niziolek.

Finally, of course, the individual consumer is trying to save money. This theme encapsulates innovative stock management systems pursued by the Polish Bedronka supermarket chain, run by Portugal’s Jerónimo Martins, which deliver customer savings through economies of scale. But it also feeds into the major IT overweights yet again: “A lot of our largest holdings are tech-consumer hybrids,” says Thakor.

## Mobile

Sands Capital is alone among the three in having a consumer-sector overweight. But as Niziolek at Calamos – underweight both staples and discretionary – points out: “In other sectors like IT you’ll see consumer exposure – and overall, the portfolio is tilted towards the consumerism theme.”

Calamos’ top 10 includes the daddy of tech-consumer hybrids, Amazon, but also plays mobile devices extensively. “That can be seen as both a consumer theme and a productivity-enhancement theme that starts with Apple and goes all the way through the supply chain,” says Niziolek.

Those include the obvious names like ARM, ASML, TSMC and Qualcomm, but also less obvious ones like Google or even Discover Financial Services, one of the leading global payments networks alongside Mastercard and Visa and a holding in the Artisan portfolio. It is growing

internationally following its acquisition of Diners Club, but Hamel also feels that it is better-positioned to support “new-age” payments systems like PayPal, Squirrel Square or Google’s Digital Wallet than its two big rivals because it is seen as a more open network. “Discover just entered into a joint venture with PayPal to become its interchange provider for all offline transactions,” he notes.

Just as underweights in consumer stocks can hide significant consumer exposure via IT, so regional allocation can hide significant exposure to the emerging consumer – particularly at Calamos, which has 29% of its assets in European stocks.

“It might look like we have a lot in Europe, but the point is where we are getting revenues from,” says Calamos. “For all the bad news going around, we need to remember that there are more people coming out of poverty and into the middle class today than ever before in history.”

So, while Brazil’s own Ambev is in its top 10, pure-play consumer stocks are underweight and the focus is more on “global companies with significant emerging market revenue exposures” in consumer-tech (such as Amazon) or consumer-materials (such as agri-business).

“It’s increasingly important that companies are truly global and can manoeuvre themselves around the world,” says Calamos. “Individual countries can make monetary or fiscal policy mistakes and when they do, capital can flow away very quickly. Mid-caps very much based and ▶

### MERCER Investment performance survey of global equity (actual ranking) Top-25 return in euro (before fees) over 3 mths, 1 yr, 3 yrs, 5 yrs ending June 2012

Manager/Fund	3 months		1 year		3 years		5 years	
	(%)	Rank	(%)	Rank	(% pa)	Rank	(% pa)	Rank
Sands Capital Mgmt - Global Growth Equity	-3.58	439	14.46	52	27.19	1		
Cedar Rock - Portfolio	4.92	15	23.31	5	27.04	2	7.89	2
Magellan Financial - Global Equity	4.67	19	31.94	2	26.47	3	11.08	1
Independent Franchise Partners - Global Franchise	3.10	39	23.40	4	25.48	4	7.83	3
Morgan Stanley - Global Opportunity	-3.26	420	6.30	261	25.09	5		
DSM - Quality Global Focus Equity	-0.68	227	20.10	11	24.75	6		
Artisan Partners - Opportunistic Growth	0.02	164	14.53	49	24.74	7	5.84	11
Calamos - Global Growth Strategy	-1.75	330	11.37	94	24.21	8	6.50	8
Morgan Stanley - Global Franchise	1.61	74	21.37	8	23.84	9	6.97	5
Cantillon - Global Equity	2.30	60	17.04	28	23.57	10		
Delaware Invs - Focus Global Growth	-1.60	315	14.48	51	23.34	11		
Causeway - Global Value Equity	-1.74	329	10.85	115	23.02	12	0.06	115
Guardian - Global Equity GPS	2.67	51	13.02	70	21.98	13	3.93	20
BL&S - Fundamental stock-pick	0.05	159	11.13	105	21.75	14		
Vontobel (US) - Global Equity	0.82	103	22.79	6	21.49	15	4.43	16
Astrian Partners - Artisan Global Value	2.29	61	18.82	17	21.40	16	4.85	14
Swisscanto - Selection International	0.81	105	13.38	63	21.38	17	1.96	58
Marathon - Active Global Equities	1.06	97	7.65	219	21.32	18	1.86	60
Marsico - Global Growth	-2.03	358	7.87	211	21.11	19		
M&G - Global Equity Unconstrained - Global Dividend	0.00	166	12.01	87	21.11	20		
William Blair - William Blair & Company	-0.77	237	14.53	48	20.59	21	3.06	31
Sparrow Capital Management - World Tot Ret	0.57	117	17.07	27	20.56	22	-2.98	264
Gramercy Advisors - Global Optimization								
Strategy-Global Equity	-2.97	400	4.08	331	20.39	23	1.66	66
PanAgora - Dynamic Global Equity Extended Alpha	0.37	136	11.24	102	20.37	24	2.56	43
Kleinwort Benson Inv - Agribusiness	1.67	72	4.68	315	20.23	25		

## Benchmarks

FTSE World	-0.59	217	7.76	214	15.18	189	-0.90	163
FTSE World Growth	-0.58	216	9.42	155	15.64	156	-0.51	143
FTSE World Value	-0.59	217	6.11	266	14.71	216	-1.37	189

## Group Statistics

Upper Quartile	0.40		10.58		16.80		1.06	
Median	-1.06		6.67		14.92		-0.95	
Lower Quartile	-2.76		2.36		12.36		-2.49	
Number		523		481		405		331

◀ focused on their home countries will be less able to cope with those developments.”

They take a different view at Sands Capital, where the past decade has been spent developing what had been a US-centric research capability into a 30-strong team dedicated to global fieldwork. The result is a marked emerging markets overweight in both stocks and revenues.

“Owning a Nestlé or Avon may be an American or European way of owning EM, but we’d much rather own EM the organic way with Tingyi or Natura Cosméticos,” says Levanson. You might get 20% of a more established, financially-strong European business exposed to emerging consumers, he concedes, but that pales next to the 50% Chinese market share in tea and instant noodles enjoyed by Tingyi, let alone its unmatched distribution advantage and local cultural knowledge.

For Artisan, while the theme of the global con-

sumer is attractive, the valuations are not. The “combination of rich valuation with modest top-line growth” puts him off the global titans. Most recent additions to the ‘Garden’ portfolio have come from outside the US, and Hamel prefers local mid-cap consumer staples, but while some quasi-consumer names are big in the portfolio – Anhanguera, Brazil’s leading provider of tertiary professional education; healthcare insurer Qualicorp; and dental HMO OdontoPrev – genuine consumer positions remain small because of valuations. Jubilant Foodworks, licensee of Domino’s Pizza and Dunkin’ Donuts in India, trades on 55 times P/E, for example; Brazilian drugstore chain Raia Drogasil is on 42 times.

It just isn’t necessary to pay that much for growth today. Indeed, the one consumer name that Hamel picks out as being more reasonably valued – Chinese brewer Tsingtao, on 24 times earnings – seems to be priced that way because

it is about to enter a new re-investment phase. That takes us back to our starting point: investment for growth is unloved by the market.

“In this part of the market cycle we see a consolidation of values,” as Calamos, sporting the lowest portfolio P/E of the three, puts it. “You can hardly tell the difference between a value stock and a growth stock. I don’t think many people recognise this. While we want to talk about growth prospects, everyone else is focused on the next quarter and won’t look 2-3 years out to when sentiment has improved.”

When it does improve, he argues, the performance differential between growth and value will move “very, very quickly” from 100-200 basis points to 1,000 or more. “I don’t know when it’s going to turn, but we are well-positioned when it does,” he says. And key to that position are those three master themes: money-saving, mobilisation, and emerging consumption.

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