

Manager Q&A: Hunting For Growth With Evan Bauman *Featured in Seeking Alpha*

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*With markets in turmoil, Seeking Alpha is reaching out to investment managers with proven long-term track records for their perspectives on successful stock-picking practices. The following presents Evan Bauman, the Co-Manager of the **Legg Mason Clearbridge Aggressive Growth Fund**, an all-cap aggressive growth portfolio. Bauman recently sat down with SA to discuss the approach that he and fellow manager Richie Freeman employ to find great long-term growth stocks at attractive valuations, particularly in markets like these.*

Your fund invests in some of the most volatile businesses out there – biotech, technology, energy. How can anyone look out over a 5-year time horizon in these fast-changing businesses to find good stocks that can be held for several years?

There's no question that biotech and technology can be volatile, especially earlier stage companies in these sectors, however, I'm a believer that if you look for a few important characteristics these are two of the most appealing long term growth areas. When we buy a biotech company, we look for drugs that treat unmet medical needs with a novel and innovative method of treating that disease. When a company finds a new treatment, they get at least 12 years of patent life around that drug and often can capture a big part of the market in a short period of time. We love companies with strong balance sheets who don't need constant access to capital markets (one of the things that can add to the volatility of small cap biotech). A couple of names we own today which fit that theme include **Vertex (VRTX)** which recently launched Incivek for Hepatitis C and **Human Genome Sciences (HGS)** which launched Benlysta to treat Lupus. In addition to Incivek, Vertex has a very interesting pipeline of treatments for cystic fibrosis. While these companies can have high binary risk around approvals or quarterly results, these are companies that can grow substantially during economically stagnant times.

Our technology holdings also speak to our view on the importance of innovation, balance sheets and their IP (intellectual property) portfolio. We own companies which are solid financially and are targeting large markets with sizable and growing opportunities. Examples of this include **Sandisk (SNDK)**, the largest US manufacturer of flash memory and **Broadcom (BRCM)** which manufactures and sells communication chips. In both cases, these companies are benefitting from the portability of media and the huge increase in digital content and data worldwide. As smartphone and tablet usage increases, Sandisk enables the storage on these devices and Broadcom enables the connectivity thru chips that incorporate wifi, Bluetooth and new technologies like NFC (nearfield communications). We also own **Citrix (CTXS)** which allows individuals to access computers and applications remotely and is becoming a major player in cloud computing and virtualization. Finally, a company called CREE, Inc. (**CREE**) is a leading manufacturer of LED (light emitting diode) chips and fixtures which is

leading the energy efficient lighting revolution. We feel that the use of LEDs in general lighting applications will grow dramatically in the next five years worldwide. In each of these cases, while quarter-to-quarter volatility can be significant, the opportunities for growth are substantial.

If you look for strong, long-term growth companies, how do you avoid overpaying for businesses or predictable earnings streams?

Despite running a fund called the Aggressive Growth Fund, Richie Freeman and I are big believers that growth investors who ignore valuation are ultimately destined to fail. While the companies in our fund are growing rapidly, they trade at a P/E ratio which is in-line with the benchmark. Our focus on balance sheet cash, and significant cash flows means that our fund's average Price/Book ratio is about half that of the benchmark. It's no surprise that when we get into a market where high valuation names contract (think early 2000s), the kind of companies we own our fund perform much better on a relative basis as well. In addition, buying stocks when they're cheap often means bigger companies target our holdings for strategic acquisitions. We have had a number of companies bought out of our portfolio in the past (Genzyme, Millenium Pharm, Imclone and Chiron, to name a few).

Today's investment world gets overly dissected and caught up in generalizations. I have heard that large cap quality growth stocks have underperformed for years, but names like Apple (AAPL) and Exxon (XOM) (which clearly fit that description) have outperformed. Therefore, to me, I worry less about whether a stock is classified as growth or value and more about the opportunity for a company to grow consistently on a secular basis. There are a number of growth and valuation metrics that we look at but PE/Growth rates are important. Typically, I want a company that trades below 1.5 times its growth rate and I want that growth rate to be long term in nature.

Absolute P/E or growth rates can be deceiving at times. I'd rather pay 10 times earnings for a 12% consistent grower than 50 times earnings for a company growing at 20% per year. In addition, we've often said that a "Growth" stock is one that goes up. In other words, my goal is to make clients money on an absolute basis. In 2008-early 2009, when everything was on sale, we bought some more cyclical names like Freeport-McMoran Copper & Gold (FCX) and Fluor (FLR) because they were cheap on a mid-cycle earnings basis and the beneficiaries of a reflationary backdrop. I'd never say never to any sector.

Some are arguing that in today's world – where global equities and even different asset classes are increasingly correlated – that all investors need to start thinking more like hedge funds. How do you view this issue and what do you think?

There's no question that correlations have been high recently (in fact the last time they were this high was post '87 crash), and I think this is a function of the crisis of confidence we're operating in right now. No one trusts governments at home and abroad and fear levels are high. The macro situation has been the tail that's been wagging the dog. Currency prices drive commodity prices which then move equity prices- shampoo rinse repeat. Risk-on, risk-off have become common phrases.

That said, I don't believe this is the time to abandon our discipline of high-quality growth companies that, for one reason or another, are priced reasonably compared to their future prospects. High correlations don't last forever and also lead to opportunities (i.e., the highest quality, fastest growing assets sell off along with others – this is the baby-with-the-bathwater syndrome). I believe the backdrop for equities is actually very favorable right now. Rates are low, liquidity is enormous (both on a corporate and central bank level) and fear is at record levels. After the recent selloff, valuations, – especially versus fixed income assets – are very attractive. History has shown that times like these are the best opportunities to acquire high-quality equities.

How do you keep your discipline while the market is melting down and fear is rampant - and few people are able to take a dispassionate look at valuations.

I feel that having a long-term approach helps us in volatile times. Remember that we have run money in our mutual fund since 1983, during which time there have been many other times of extreme volatility. One thing

volatility leads to inefficiencies in the market. When individuals panic or face margin calls, and funds sell to meet redemptions like we've seen recently, they sell what they can or have to, not what they want to. With our multi-year investment horizon, we can add to positions during these periods at very attractive price levels when others are forced to sell. Again, looking at history, some of the greatest moments of fear were also the greatest moments of opportunity.

What areas of the market – and perhaps some stocks – look most attractive to you now?

The biggest areas of focus for us are Healthcare, Energy, Technology and select cable/media holdings. I think you need to find companies that can show real organic revenue growth in this slow growth (at best) economic environment. A company like **Biogen Idec (BIIB)** in the biotech space can quadruple its earnings in the next decade as a result of new product launches and the growth of existing products. Within the energy complex, companies like **Anadarko Petroleum (APC)** and **National Oilwell Varco (NOV)** are benefitting from an unprecedented international drilling cycle. The demand for oil from emerging economies like China, Brazil and India is game-changing and these companies have had great success finding new sources of hydrocarbons around the world.

Does an investor need to look at a small-cap company in a different way from a mid- or large-cap company? Does it affect the way you pick issues?

We run a unique fund in this respect. Many of our companies are originally purchased as small- or mid-cap stocks but are held onto as they grow from small to mid- or mid- to large-cap. Regardless of market cap, we want companies that are well funded and have a compelling product or service offering. Some of our best performing names are large-cap companies who are trading at good valuations and continue to grow. Examples of this include **UnitedHealth Group (UNH)**, which we purchased in the 1990s and has continued to show excellent growth in earnings and free cash flow and Genzyme, which we bought originally as a small cap name in 1989 and sold earlier this year to **Sanofi Aventis (SNY)** in a \$20 billion takeover.

How do you think your approach differs from other growth managers seeking great long-term performance? Any advantages you would point to give you an edge?

In some respect our fund is one of the last of a dying breed. So many fund managers are benchmark-sensitive today and feel compelled to turn the portfolio over often. We are bottoms-up, benchmark-agnostic managers who focus most heavily on finding a selective group of companies that can grow sustainably over a long time period. We trade when there's a reason to, not to meet some pre-defined turnover target.

While takeovers are what I call "good" or "easy" turnover, we also sell when valuation gets excessive – using a variety of metrics, depending on the industry – or when we have a better use for the cash. If we see a company's balance sheet beginning to degrade (debt/total cap levels rising or cash levels declining) we're more apt to review the stock for a sale. We've been called contrarian, but I prefer to think of it as experienced. We've been through bear markets before and realize that short-term volatility doesn't last forever. When you remain focused on a company's intrinsic value and long-term earnings potential, either the market will come around to it, or another company will monetize it.

The original article can be found here: <http://seekingalpha.com/article/308754-manager-q-a-hunting-for-growth-with-evan-bauman>

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Top ten holdings (%) as of 12/31/11: Biogen Idec Inc 9.9, UnitedHealth Group Inc 9.2, Anadarko Petroleum Corp 8.4, Amgen Inc 5.9, Comcast Corp 5.3, Weatherford International Ltd 4.7, Core Laboratories NV 4.0, Forest Laboratories Inc 3.7, SanDisk Corp 3.1, Tyco International Ltd 2.6.

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As of 12/31/11, Genzyme, Millenium Pharmaceuticals, ImClone, Chiron, Apple, Exxon and Sanofi Aventis are not holdings of the LM CBA Aggressive Growth Fund.

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Diversification does not assure a profit or protect against market loss.