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WINNERS' CIRCLE

WHAT VOLATILITY? GROWTH-FUND MANAGERS STRUT

By Suzanne McGee

The first three months of 2018 were a volatile period, culminating in the S&P 500's first quarterly loss since mid-2015.

But behind the scenes, some disciplined mutual-fund managers who focus on "growth" stocks—those powered by corporate-earnings potential—continue to rack up gains. In fact, they are dominating, led by the $2.5 billion Virtus KAR Small-Cap Growth Fund (PXSGX), which has won The Wall Street Journal's latest Winners' Circle contest of the best-performing U.S.-stock fund managers. It returned 40.8% in the 12 months ended March 30 (drubbing the 19.9% gain for small-cap growth funds overall, as tracked by Lipper).

The Virtus KAR fund and other growth-stock funds have focused on the "micro" part of their job—looking for companies with solid fundamentals—while ignoring "macro" issues, such as rising interest rates, the chances of a trade war with China, or the question of whether valuations of market darlings such as Facebook and Netflix are sustainable.

"A lot of people have underperformed because they have made too big a deal about macro factors, from the Federal Reserve to Trump," says Doug Foreman, chief investment officer of Kayne Anderson Rudnick, which manages the Virtus KAR small-cap fund. "They have missed the improvements in corporate America: the stuff that companies have invented, the way companies have deployed capital and so on. All of which translates into great growth."

Mr. Foreman and his colleagues haven't made that error, which is why Todd Beiley, manager of the Virtus KAR fund, is our contest winner.

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The winner: Todd Beiley at Virtus

Contest rules

Although our contest is quarterly, its goal is to identify the actively managed, diversified U.S.-stock fund—with at least $50 million in assets and a record of more than three years—with the best 12-month performance. Index funds and exchange-traded funds don't qualify because they aren't actively managed; we also disqualify leveraged funds, since they don't measure a manager's stock-picking prowess.

While we don't factor in fees (our goal is to identify skilled fund managers) anyone looking for funds to add to their portfolio likely will want to consider the impact of management and sales fees, as well as the sustainability of returns, before making any investment decisions.

For the period ended March 30, every top-performing mutual fund once again featured growth in its name. Indeed, 77% of growth-stock mutual funds outperformed their benchmarks in the first quarter of 2018, a record since Bank of America Merrill Lynch began tracking this data in 2009, when only 9% succeeded in beating the relevant Russell 1000 Growth index.

Primecap Takes No. 2 Spot

However, many managers are taking a broader approach to what represents "growth" than the traditional internet technology and biotechnology firms. That includes second-ranked fund Primecap Odyssey Aggressive Growth (POAGX), with a 37.6% return. While its top holding is a classic biopharmaceutical enterprise, Nektar Therapeutics, the fund's portfolio also includes Delta Air Lines and JetBlue Airways—not traditional fare for growth investors in recent decades.

Morgan Stanley Investment Management had two of the top six funds on the Winners' Circle list: Morgan Stanley Multi Cap Growth (CPOBX), with a gain of 37.2%, and Morgan Stanley Institutional Growth (MSEQX), up 35.9%. Dennis Lynch, head of growth investing at Morgan Stanley, is reluctant to be rigid in his definition of what qualifies for inclusion in such funds. But by the end of 2017, he says, the funds' exposure to tech was lower than a year earlier.

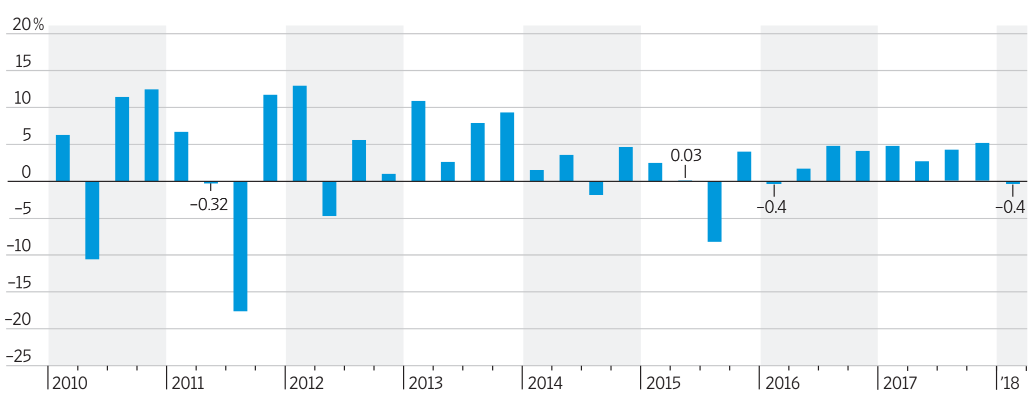
Hunt for 'disruptive change'

Rather than assume that growth is to be found primarily in technology or biotech, Mr. Lynch takes an iconoclastic approach to finding companies. His team includes two "disruptive change" researchers, whose mandate is to identify those businesses whose models will profit or suffer from tectonic shifts in the way American corporations function.

Today the Morgan Stanley

The Score at the Quarter

First-quarter 2018 losses for U.S.-stock funds overall broke a seven-quarter winning streak (measured by average total return of U.S. diversified funds). The bright spot: Growth-stock funds bucked the trend with gains of about 3% on average.



Source: Lipper

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growth portfolios include such companies as Starbucks and Union Pacific. The latter offers many characteristics that would appeal to value investors—attractive dividend yields and a price/earnings ratio that is at or below the market average. But it has been a beneficiary of the new tax law; analysts predict Union Pacific will post a big gain in first-quarter profits (from $1.32 a share last year to $1.67) when it reports on April 26. The company, which also has raised dividends twice since late last year, is one of the 10 largest holdings of the Institutional Growth fund.

Mr. Beiley also is drawn to some nontraditional sectors. While many see financial stocks as value holdings, he expects that Interactive Brokers, a low-cost, customer-friendly brokerage firm, will boost market share as its business environment continues to improve. The stock price has climbed to about $69 from the fund's cost basis of $37.

Mr. Beiley can allocate, at most, 20% of his fund's assets to non-U.S. companies, some of which contributed significantly to the fund's returns. China's Autohome—operator of the country's major automotive-focused website, ranging from dealer links to independent car reviews—led the way, after being a big loser in 2016. After trading as low as $20 in 2016, the stock rebounded to close 2017 at around $65, and now $88.

The kind of stocks Mr. Beiley and his team seek out sound remarkably like value-priced growth stocks, or value stocks with growth potential. "Our preferred situation is to find a company with a good underlying business that is facing challenges in the near term, and whose stock price doesn't accurately reflect its long-term potential," he says.

Entering the 10th year of a bull market, with valuations climbing along with the nerves and unease, that may be an entirely new category: safe growth.

***Ms. McGee** is a writer in New England.*

To learn more about the Virtus KAR Small-Cap Growth Fund or the other strategies managed by Kayne Anderson Rudnick, please contact us at 800-243-4361 or visit Virtus.com.

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This reprint must be accompanied by a current fact sheet for the Virtus KAR Small-Cap Growth Fund.

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