

# THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

## Investing in Mid & Large Cap Growth Stocks



JOSEPH H. RAY has been a Portfolio Manager and Analyst with Gerald L. Ray & Associates, Ltd., since 1989. Prior to that time, he was a securities attorney with a major Dallas law firm. He is a graduate of Emory University and the University of Texas School of Law. He is married and has three daughters.

**(TAQ502) TWST: Can you begin with an overview of Gerald L. Ray & Associates, Ltd. and its investment philosophy?**

**Mr. Ray:** We're a Dallas-based money manager. We have four managers and 13 in our group overall. We manage about \$550 million primarily in equities, with some fixed income. Our business is two-thirds individual investors and one-third institutional investors. Regarding our philosophy, in an equity portfolio we have a foundation of high quality, large cap growth stocks that may be 60% or 70% of a portfolio. The remainder is in mid-cap market leaders, turnarounds, and areas that we think have just gotten too cheap relative to the market.

**TWST: Do you do any macro analysis of the economy or of industries?**

**Mr. Ray:** Yes, stock selection is done taking both a bottom-up and a top-down approach. We look at where we think we are in the economy, what areas in the stock market could do well as it relates to that, and we'll often pick out stocks in that group that we're favorably disposed to. It can work the other way also, where we discover a company that we're interested in, and then we do our work that way. So we can take an individual company approach as well.

**TWST: How have your portfolios done over the last 12 months since we spoke to you, and how have you been positioning them for future growth?**

**Mr. Ray:** We feel pretty fortunate, because last year we felt that the economy was slowly starting to pick up, and when we saw the dips last July and then again in October we got fairly aggressive in our approach to the market. Since last September, the last four quarters,

we've done quite well, with equities up north of 30%, compared to 24% for the S&P. We had a good feeling about where the market was going at that time, and fortunately we were able to take advantage of it.

**TWST: What are your sector weightings at this time? Where are you overweight and where are you underweight?**

**Mr. Ray:** Because we have a growth bias, we've been underweighted and traditionally are underweighted in areas like utilities and energy. Generally in the past, we've been underweighted in cyclicals also. I think part of the reason for our success this year is that we did take small positions in certain commodity-based cyclicals, like **Alcoa** (AA), which is a little bit unusual for us, but has worked out well.

Going forward and in terms of where we're positioned now, we always have a nice representation in health care. We also own what I call cyclical growth areas, such as advertising and names like **Clear Channel** (CCU) and **AOL** (AOL). There are the more traditional conglomerates like **Honeywell** (HON) and **GE** (GE), and we still think that the banks, which were good to us in the first part of this year, still have room to go to the upside.

**TWST: What are your views concerning diversification portfolios?**

**Mr. Ray:** Our portfolios are fairly concentrated. In an average portfolio we'll have 30 to 40 names. We feel that with many more than that, you tend to look too much like the market. So what we're trying to do is concentrate it just enough, so that you can get the benefits of diversification, but at the same time, if something really works, accounts can benefit.

**TWST: Do you do any rebalancing of assets in your portfolios?**

**Mr. Ray:** Yes, it's a constant process for us to continue to rebalance. If we're fortunate and the stock does what we think it will, we'll sell a portion of the position as the stock goes up. But more often than not, if it's been a successful company, we'll hang onto it. Our time horizon tends to be long term, and we'll just sell off shares to diversify further as we add new names. If a stock doesn't do what we think or there's a change in management or what we perceive to be a change in the fundamentals, we'll go ahead and sell it.

**TWST: What are the actual characteristics that you're looking for in these companies, and what are your valuation metrics?**

**Mr. Ray:** In terms of the base of the portfolio, the growth stocks, we tend to look at companies that are market leaders. They tend to be large cap. We would like to buy them somewhere around their growth rates if possible, or, at a minimum, cheap relative to the group. In terms of areas outside of that, we'll look at things like free cash flow and management and other areas that may be more subjective.

**TWST: What are some of the major stock holdings in your portfolio?**

**Mr. Ray:** Some of the largest holdings are **Southwest Airlines** (LUV), **Amgen** (AMGN), **Citigroup** (C) and **Pfizer** (PFE). Those are the four largest.

**TWST: They're all well established, large cap companies. Why are you attracted to them specifically?**

**Mr. Ray:** Those are all stocks that we've owned for long periods of time. We put a lot of emphasis on management, and we feel good about the managements of all of those companies. **Pfizer** is a stock we would continue to buy. We think it's cheap, and even though there are problems within the large cap pharma group, we think this continues to be the best positioned and is inexpensive. We've owned quite a bit of large cap pharma through the years, but actually we probably own less now than we have in a long time. But we still feel that **Pfizer** could be an interesting name in here.

**Amgen** is a stock we've owned for about 10 years that has worked out really well. We still think there's some growth ahead of it and we're pleased with the way Aranesp is taking off, not only here in the States, but also in Europe.

**Citigroup** has had some management issues, but we think it's inexpensive here, and we feel that it is an excellent and inexpensive way to play financials that are outside of mortgage and some other areas that may slow up next year. It's a financial that could benefit from higher transaction volumes, solid international growth and some other things we would expect next year.

**TWST: Have you picked up any new names over the last 12 months and what were the reasons why you were attracted to them?**

**Mr. Ray:** In the healthcare area probably our newest name is **Cardinal Health** (CAH, \$58), which is a stock we've looked at on and off through the years and has always been too expensive. It's

done quite well, but it's pulled back as there has been a slight slowing in their growth rate, as well as some issues concerning their drug distribution business and how that's going to work going forward. We feel that the management is experienced and it's a good, solid company, and with numbers next year north of \$4, somewhere in the \$4.25 range. This is a top company in the industry that has now gotten cheap enough for us to buy, and we think that this will be a good stock going forward.

Another new name for us is **Clear Channel**, and there have been issues there. But, once again, it's a market leader. It is the largest owner of radio stations, and we look for advertising to pick up this year, and into next year. We have elections and the Olympics coming up, which should benefit advertising. And we think the stock is cheap at around \$40, and could be north of \$50 sometime next year.

**TWST: Is Clear Channel still tightly controlled by the Mays family?**

**Mr. Ray:** Yes, it's pretty tightly controlled. All the issues about corporate governance, etc., were one of the reasons the stocks had suffered, although clearly I think the larger reason is that advertising spending was so weak. We, however, feel that they've done a good job of putting a formidable company together, and now it looks cheap to us in terms of cash flow and a number of other metrics.

**TWST: Are there any other companies you can tell us about?**

**Mr. Ray:** In that same area, we think that another somewhat controversial name, **AOL**, is cheap. They've begun to refocus and the stock has seen its lows, and we could see the stock somewhere in the \$20s next year. Once again, they have some leverage to advertising, but I think, more importantly, they've begun to understand what it takes to rationalize their portfolio, bring down debt, and increase cash flow, and we just think it will be a better managed company. Nobody can question the quality of its assets.

The **AOL** problem in dial-up is a problem, but the reality is it's a fairly small portion of their business, and I think even the name change suggests that they're willing to look beyond that and look toward growing the rest of the company.

**Honeywell** (\$27.50) would be another stock that I think is cheap. There is new management there, as they brought in the head of TRW to run the company, and I think that's another stock that has some leverage to a cyclical rebound. It also has some leverage to defense, and we think the stock is inexpensive here.

**TWST: What stocks have you sold or trimmed back on? Can you tell us the sell discipline?**

**Mr. Ray:** The sell discipline can be based on a number of things. We might sell because we see a deterioration in the business, or because we've lost confidence in the management and we don't agree with what they've done, or because, on a more positive note, if a stock has appreciated, we want to keep it in line. But recently we have trimmed our representation in large cap pharma. We've always had a pretty good representation there. It served us

well in the mid- and late 1990s, and actually we were quite overweighted there for some time. But names like **Merck** and **Wyeth**, which were pretty big names here, aren't any longer. So that's one area where we've sold.

Another area that we've lightened up in has been the software area outside of **Microsoft** (MSFT). We feel that the growth in technology and the leverage is going to be more in the hardware area. A name that has been sold there is **BMC Software** (BMC).

**TWST: What is the turnover generally?**

**Mr. Ray:** The turnover runs about 30%, so you can see our time horizon is longer term.

**TWST: How do you attempt to manage risk in the portfolios?**

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**Mr. Ray:** We don't do options. In some cases, for some individuals and institutions, we do have a debt component, which obviously reduces volatility, and in other cases we do it by hopefully having a good understanding of the companies that we own and having some diversification of industries and types of companies. We also maintain cash in times of uncertainty.

**TWST: Do you play the volatility in the market to your advantage?**

**Mr. Ray:** We use some technical analysis to try to figure out where we want to get into stocks and where we think we may want to get out of stocks, or if we want to lighten up on a particular name. We also have internal indicators that we run to figure out whether we're overbought or oversold, and maybe we will buy or sell based on that information. Because of our longer-term orientation, volatility may provide entry points or exit points, but outside of that it's not a big factor for us.

**TWST: What about tax efficiency? Are your investors concerned about that?**

**Mr. Ray:** There is some concern. I think our clients' expectations are that we'll be fairly efficient in our taxable accounts. This tax efficiency is helped in part because our turnover is low, but also at the end of the year we review our taxable accounts and figure out if there are ways we can effectively reduce any tax obligations they may have. We take an individual, personalized approach with our clients and we talk to them. Anyone who has specific tax issues generally gets in contact with us and we try to be as helpful as we can. We feel this is a key difference between our firm and mutual funds.

**TWST: Have there been any changes in attitude on the part of your investors, perhaps asking you to look into dividend stocks to get more yield?**

**Mr. Ray:** I think there has been some emphasis on dividend increases. I think there has been some actual return of the animal spirits, if I can use that expression, and some willingness to look at stocks again. There came a point when people weren't really concerned about relative performance, and they wanted to make money again. This year has been nice from that respect. But, I think, people are looking at dividends, especially with bond yields so low, and a number of our names provide that. So in answer to your question, yes, I think people have looked at dividends, but people have returned to other stocks I think in a small way also.

1-Year Daily Chart of Honeywell



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

**TWST: You mentioned management performance earlier. Is one of the concerns about corporate governance?**

**Mr. Ray:** I think corporate governance is an issue. At times I wonder what that really means. We try to look at situations where managers have run companies before and have done a good job, and that often will lead us to a new name if they change positions. We want to have some confidence in the management, and we would like to see the management have some experience. But I think corporate governance is a hard thing to put a finger on, and it's hard to know precisely what concerns would make you not own a stock. In some cases stocks are so cheap because they have not been well managed, and there is upside in those cases. So you have to look at those companies also.

**TWST: What is your approach toward the management of fixed-income securities?**

**Mr. Ray:** Fixed income is mostly used for yield enhancement. We tend to be relatively short to mid-term in duration. We stick to higher quality issues. And while, as a firm, we are predisposed to equity investment, we use fixed income for those clients who want to see increased yield.

**TWST: How did your portfolios do during the long bear market, and what has been the performance year to date?**

**Mr. Ray:** During the bear markets they held up reasonably well, although 2002 was a pretty difficult year. We did not have direct investments in the way of Internet and telecom and some of the areas that were part of the bubble. However, we somewhat underestimated the splash effect, if you will, of some of those companies going down the way they did. So while we held up well in 2001, 2002 represented our only year of poor relative performance. As I suggested earlier, in 2003 and for the last 12 months, the portfolios have done quite well, and in the last 12 months ending 9/30, equities are up about 30%.

**TWST: What is your outlook for the stock market and the economy going forward?**

**Mr. Ray:** We think that in terms of the market and the economy, while the economic recovery to date has been slow and for the most part has been jobless, there is significant economic stimulus in the system. The Fed's monetary policy has been such that rates are very low, and it's possible they will remain on hold. The tax cuts are a powerful fiscal stimulus. Worldwide economies seem to be picking up. We're seeing some signs of recovery in Japan. Europe continues to cut rates. And oil prices, which have been pretty sticky, seem to be softening, and that could act as a worldwide tax cut. So we look for the economies to be pretty good next year. I don't think President Bush is going to make the same mistake that his father did, and because of that we look for pretty good earnings. So our market bias remains upward.

I do think that we're probably in a short-term consolidation phase. We've seen the market do fairly well. However, we haven't seen the impact of the financial leverage and gross margin expansion potential fully reflected in corporate earnings. I think once that happens we'll have a second leg up, because I believe there has been underestimation of the leverage in some companies that we would be able to see, even with moderate sales growth increases.

Regarding the bond market, we have rates that are still near 40-year lows, so we would not be too excited about bonds over the next one to two years. We believe that while there will not be significant increases in interest rates, there won't be much in the way of capital gains in the bond market going forward.

**TWST: If you had an inflow of money today to buy a couple of stocks or to add to positions, what would you do with it?**

**Mr. Ray:** I think I would go back into some of the names that we've talked about today. I would also place some money in banks, and I would take a smattering of technology holdings. We would tend to stick to the larger names, because we don't consider ourselves a tech shop, and we feel we can get most of the benefits by playing the **Intels** (INTC) and **Applied Materials** (AMAT) and **Ciscos** (CSCO). But I would diversify it along those lines — some of the cyclical growth areas, advertising, and health care.

**TWST: What does your firm bring to the table that you feel sets you apart from other peer companies?**

**Mr. Ray:** What we hope we do is provide solid investment management along with a real desire to provide personal service for our clients. Any of our clients can talk to Gerald Ray or me or Michael Beck, any of the managers here directly, and we try to be as responsive as we can. We understand that it's their money and we're only stewards of their capital.

**TWST: Where do you get your research from?**

**Mr. Ray:** We use some institutional research, but we also talk to companies directly and go to conferences.

**TWST: What advice would you leave with investors today who are looking to enter or perhaps re-enter the market?**

**Mr. Ray:** Our advice would be to choose investment options that they are comfortable with. Try to understand what your money is doing and try to have a feel for whom you're working. I think people got out of their comfort zone both on the way up and on the way down, and people would be well served to keep their long-term investment goals in mind vis-à-vis the short-term excitement the market can create on the upside and downside.

**TWST: Is this a good time to enter the market and buy stocks?**

**Mr. Ray:** For the longer term we're predisposed to equities. We feel there's a second leg to this market, and we would not be uncomfortable owning or buying stocks at this time.

**TWST: Thank you.**

*Note: Opinions and recommendations are as of 10/13/03.*

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