CHAPTER ONE

RICHIE FREEMAN

SMITH BARNEY
AGGRESSIVE
GROWTH FUND

To Richie Freeman, the fund he manages, Smith Barney Aggressive Growth Fund, is more than just a collection of $8.0 billion in investor assets; it is a collection of individuals who entrust him with their college money, savings for a new home, a comfortable retirement, and other dreams. Managing individuals' money is not just a career for Richie; it has been his lifetime passion. While his track record speaks for itself—during the 10-year period through 2003 the fund returned a compound, annualized 15.04 percent to his investors, nearly four percentage points better than the S&P 500 and almost six percentage points better than the Morningstar average peer fund in the large-cap growth category (Morningstar currently ranks his performance as number one over this time horizon)—he is simply determined to make money for his investors.

Indeed, his winning performance is based on a philosophy that he began developing at 13 years of age. Up until that point, the youngster had only aspired to be a baseball player. Little did he know that he would be given a present that would forever change his life.

Richie's father, Ted, deserves the credit for having nurtured his interest in the stock market. In the early 1960s, Ted placed some of Richie's savings into a mutual fund, helping drive home the benefits of diversification to the young investor. In an oft-repeated expression, Ted would tell young Rich, "One day you will work hard for your money. You should always remember to make your money work hard for you." While some relatives thought it wrong to allow a youngster to spend time hanging around a brokerage office, Ted and Richie's mother Eleonor encouraged Richie. "Sitting in that brokerage office on Kings Highway in Brooklyn was the best undergraduate training a stock market enthusiast could get," says Richie today.

In 1966, for his Bar Mitzvah, Richie received as gifts shares in several companies, including AJ Industries, an industrial concern. Routinely, Richie would wait for the late edition of the *New York Post* to check the closing prices on his stocks. Ted would regularly explain to him why the value of his positions, and thus his savings, fluctuated in price that day. Astonished that investors would change their minds so frequently about the value of his stocks, Richie sought more current information. Every day the market was open, after school and a game of stickball in Brooklyn, Richie would walk to the local brokerage office to check the tape.

In fact, during the mid-sixties, the teenager spent almost as much time watching the local stockbroker's ticker tape as he did playing stickball in the schoolyards of Brooklyn. The financial pages of his father's *New York Post* continued to fascinate him. In addition to looking at closing stock prices, he liked to tally up his mutual funds' stock positions to see how they performed for the day.

While other investors watching the ticker tape were calculating the gains and losses of their positions, Richie was doing something different. He was visualizing trends in stock prices, noticing distinct patterns in the way the stocks traded, realizing the forces behind supply and demand. Even now he says, "I don't think there's a better way to learn about the market than being intimately involved while watching the tape, really living and breathing it. At first glance the flashing numbers might appear as tedium or monotony, but after a while you will notice certain price trends developing." So enchanted was young Richie by his study of the ticker tape that, as he now admits, he "hated weekends because the markets were closed."

Every day after the market closed, Richie would estimate the value of his mutual fund holdings. Using an old Burroughs adding machine, he calculated the overall value of his mutual funds by totaling up the value of the individual holdings in the funds. The next day, he would see how close his calculation came to the published value of the fund. By the time he was 15, with his parents' permission, he was investing with his own stockbroker. "This is where I really earned my business degree," he says. "There was no better training than studying the ticker tape and investing for myself." Richie still maintains contact with his childhood stockbroker. Coincidentally, Richie and the broker now both work for Citigroup, although in different divisions.

He gives a short laugh, and describes summertime visits to another broker's office back in the sixties. "As a camp counselor in Port Jervis, New York, I would treat the kids to a hike into town so I could spend time in the brokerage office watching the ticker tape. I convinced them that the exercise was good for them."

Richie graduated from Brooklyn College and received an MBA in finance from New York University. In 1983, after spending eight years as a research analyst on Wall Street, Richie was asked to help launch a new fund, then known as the Shearson Aggressive Growth Fund. He still manages that very same fund, which is now known as the Smith Barney Aggressive Growth Fund. (Smith Barney Asset Management is part of Citigroup Asset Management.)

Though Richie tends to take less risk than his average peer, the fund has been marketed as an aggressive fund, mostly due to its exposure to small- and mid-cap stocks. Because of Richie's conservative nature, he encourages investors to diversify by maintaining only a portion of their portfolio in the fund. Even so, Richie treats the money as if it is 100 percent of everyone's money. "This isn't a game, and this isn't play money," he maintains. "I take this to heart—I hate to lose."

Richie likes to use baseball metaphors when discussing the markets, comparing the way he composes his stock portfolio to creating a baseball team. "Like a good baseball manager, my job is to evaluate individual talent and build the players into a cohesive team. Similarly, I focus on picking great individual companies that can collectively result in great performance for the fund over the long haul." During the rare times he takes away from the markets, he will check Yankees and Mets scores and statistics. His office is adorned with pictures of his family and baseball memorabilia.

The Smith Barney Aggressive Growth Fund was established to seek capital appreciation among companies that meet Richie's valuation metrics: stocks he believes will surpass the S&P 500 Index's average earnings growth. Richie has always believed that the largest gains can be earned by identifying great growth companies early in their life cycles, when they are relatively undiscovered small- or mid-cap stocks, and then holding them for the long-term. As long as the fundamental reasons he invested in a company remain intact, and revenues and earnings continue to grow, Richie tends to hold the position, sometimes even after it becomes a large-cap company.

Richie began to really feel the pressure of investing other people's money his first full calendar year on the job. It was 1984: The fund was down 12.2 percent for the year. While he harbored doubts about his ability, Richie nevertheless had the confidence in his companies to hold on and let them grow.

"I used to go home complaining to my wife Randi, 'Boy, did I make a mistake,' " he remembers. "And to add to my enormous sense of responsibility and my keen awareness of the trust that investors were placing in me, my performance was posted in the paper every day! This obsession has never gone away. If anything, it has probably increased."

One of the mid-cap companies he was buying in 1984 was a microchip manufacturer, little known at the time, called Intel. The purchase was considered a brash move at the time as the investing world believed Japan was going to dominate the computer chip market into the future. Richie saw another story; he saw a company whose stock was trading at a split-adjusted average price of 88 cents, with unique products and a management team with a solid track record. He also believed that the company was intelligent enough to invest massive sums of money in research and development to create the next generation of chips. Richie believed in the company's philosophy and positioning of its products. Now, nearly 20 years later, the chipmaker's market cap exceeds $200 billion. Richie likens this pick to the Mets picking catcher Mike Piazza, who is considered the best offensive catcher in the history of baseball. "The Mets picking Piazza is like me picking Intel a couple decades ago," Richie says, modestly attributing the pick to good luck. Other portfolio holdings that were purchased at the beginning of the fund's life and remain in the fund today include Forest Labs and Comcast.

Because of his buy-and-hold approach, Richie has earned a reputation on the Street as a "patient" investor. Richie believes that a true growth portfolio should consist of companies that can be held not for a quarter or two, but for many years so that the earnings growth can compound over time.

When selecting stocks, Richie uses a bottom-up approach, a technique that focuses on individual company fundamentals to find attractive opportunities, as opposed to a top-down method that focuses on broad economic and industry trends to identify interesting stocks. He considers himself a stock picker, not a market forecaster, opting for companies that can, in some cases, control their own destinies.

Using this approach, Richie seeks stocks that he anticipates may appreciate over a three- to five-year time frame. Unlike many aggressive growth investors, who employ a momentum strategy in buying stocks that are widely held and rapidly rising in price, Richie likes to explore areas that Wall Street has not yet discovered. He will seek out small, relatively unknown companies well before they have hit Wall Street's radar screen; generally they are not even covered by Street analysts. This strategy can give Richie's fund a tremendous boost as these stocks continue to exhibit strong growth, drawing the attention of Wall Street and the brokerage networks. Once recognized by Wall Street and the investing public, the prices of these stocks can appreciate significantly.

Overall, when looking for companies that are likely to become long-term winners, Richie forgoes rigid stock screening tools when narrowing down his potential targets. First, he looks at the management team, scrutinizing their experience and track records, and determining how those experiences would help in the new venture. He is a big believer in direct contact with management, spending time talking to management and interviewing them to better understand their skills, their philosophies, and their intentions for leading the company into the future.

Furthermore, Richie prefers that a significant portion of management compensation be tied to the performance of the company stock, thereby aligning management's interests with those of the shareholder. As he often quips, "If a stock performs poorly on any given day, I want management to go home feeling just as bad as I do."

To illustrate, in 1992 Richie bought shares in Infinity Broadcasting when it went public. He was particularly interested in the company's predictable and growing cash flow, and in CEO Mel Karmazin's exceptional capabilities in managing profitable broadcasting properties. Richie was also alert to the CEO's personal stake in the company, which was most of his Karmazin's net worth. Westinghouse acquired Infinity in 1996. Later, Westinghouse divested its industrial operations and changed its name to CBS in order to focus on its media operations. CBS merged with Viacom in 2001 and Karmazin remained with the combined company as president and COO until his departure in 2004. "Mel Karmazin is a good example of the type of manager I look for. He has an exceptional track record and his interests are aligned with shareholders." With Viacom trading in the mid-30s, Richie's adjusted cost basis is just over $2 per share.

While Richie considers management a key component in narrowing down his stock selection, he believes that even the best management team cannot effectively execute without the right goods or services. He looks for companies that have products or services that customers are virtually compelled to use, such as medicines that effectively treat serious diseases. "We invest in long-term trends, not fads," he says.

Richie wants to feel comfortable knowing that earnings and cash flow are likely to be healthy going out at least three years. He will generally consider an investment in a not-yet-profitable company if it has the potential to become profitable within a two- to three-year period, and has the cash to support the business in the meantime. The company must also have a solid balance sheet with little or no debt. However, some industries that have predictable cash flows may use debt as a financing vehicle. Then he compares the stock's current valuation with the projected earnings growth rate he forecasts for the company. He is less interested in companies that are trading at valuation levels more than two times their annualized earnings growth rate. The price-earnings-to-growth (PEG) ratio helps to determine a stock's value while taking into account earnings growth; it is particularly helpful when valuing companies that pay no dividends, such as small- and mid-cap growth stocks. "We want growth companies, but we want to buy them on the cheap," he says.

Here Richie offers an example. About a decade ago, he initiated a small position in Idec Pharmaceuticals. Subsequently, the biopharmaceutical company's leading product, Rituxan, a drug therapy for treating non-Hodgkin's lymphoma, proved effective in clinical trials, giving Richie the confidence to increase his stake in Idec. He believed the drug was unquestionably the right drug, one that many doctors would prescribe for non-Hodgkin's lymphoma once it earned approval. Even though Richie believed in the product, to him Idec was still an unproven company. One advantage: Richie had confidence in the CEO, who had a successful track record at Genentech. "I like to invest with people who have great track records at successful companies—especially if I've been successful with them in the past." Richie adds: "I also call it betting on the jockeys." Here Richie started with a modest position and then added to it, buying the micro-cap stock at a split-adjusted average price of $2 per share in the mid-nineties when its market capitalization was around $50 million. Idec recently merged with Biogen to form Biogen Idec, the world's third largest biotechnology firm.

When looking at a company's fundamentals, Richie says, "First, I look to see if the company's product has longevity. Is the product unique enough that the company will be able to sustain an advantage over potential competitors? If the product is not so unique, then you want to pay a lower price for the stock to compensate for the risk that competing products will take market share."

Richie will typically put 1 to 3 percent of the fund's assets in a new stock position. "This isn't a set number because there are so many factors," he says, such as his comfort level with risk. "As I become more comfortable that the risk level is diminishing—and hopefully the stock hasn't moved up much—then I might add to the position." In many cases, a stock may drop soon after he buys it, but he remains unfazed: "Of course, any investor would like to see everyone else jump in on a stock after you buy it, but it just doesn't happen like that; I don't get upset if the idea doesn't catch on right away," he says. "As long as my conviction remains, I'm not afraid to build a position if a stock is dropping, and I'm not afraid to go against common wisdom on the Street." The Idec investment proved to be a classic Richie Freeman investment: taking a small position in an immature company, then increasing the position as the company successfully proves its ability to grow.

"When it comes to earnings," says Richie, "I try to make my best judgment over a three-year period." This approach differentiates him from the legions of others who look only at the next quarter or six months. "As a disciplined, long-term investor, I have to count on companies missing their earnings expectations to some degree. Even companies such as Intel and Forest Labs have missed numbers. I'm more interested in whether a company is capable of achieving higher highs in earnings and cash flow over time. I can tolerate short-term disappointments if the long-term results remain strong."

Another prime example of buying early is Comcast Corporation, an operator of cable networks and programming, which Richie began buying in 1983. Comcast had a solid management team. Also, the company pursued an acquisition strategy that enabled it to steadily increase its cash flow. Richie bought more stock in 1996 because he believed that cable would become the method of choice for delivering information. Shortly thereafter, Bill Gates invested $1 billion in the company, further validating Richie's belief in cable as a major player in the broadband arena.

Richie avoided the dot-com bubble because he "couldn't place a value on the companies," he says. While many money managers ignored the lack of earnings and focused on the go-go momentum of technology stocks, Richie held tight to his valuation discipline, steering clear of the sector and largely avoiding massive losses when the bubble burst in early 2000. In 1997, however, he was able to place a value on one technology company, Netscape Communications. America Online, which itself merged with Time Warner, eventually acquired the company.

In the biotechnology sector, Richie invests mainly in companies that are already profitable or, in his opinion, have the potential to become profitable within a three-year period. Richie believes one trend in the biotech sector will continue. "Large pharmaceutical companies will continue to partner with smaller companies that have promising products," he explains. "The larger company will arrange very favorable royalty structures for the drugs, and may take an equity stake in the smaller company."

Because of Richie's bottom-up approach, some industry sectors may represent heavier weightings than others in the fund. This is especially true, considering that the portfolio may contain anywhere from 60 to 80 holdings. He limits any single holding to 10 percent of the fund's assets, thus avoiding overconcentration. The biggest reason he will sell a stock is to minimize its relative size in the portfolio. Instead of selling an entire position because of its size, Richie will merely "trim it down."

Richie generally has low turnover in his portfolio, believing that if a portfolio of growth stocks is designed properly, stocks should be held for the long haul.

The turnover of stocks in Richie's portfolio is relatively small when compared with that of his peers. With a historic annualized turnover of 5 to 10 percent, the average stock is held an almost unheard-of 14 years (over the last three years, the fund's annual turnover was only 1 percent); compare this with the average large-cap growth funds' turnover rate of

138 percent, which equates to the average stock being held less than nine months. This low turnover has made Richie's fund more tax efficient than 99 percent of all his peers over the last three and five years. While growth-stock funds actively trade securities to seek the best possible performance, Richie believes it is more important to understand the companies in a portfolio and to stick to a long-term plan. Another distinguishing feature is expenses that are well below his peers' average, which is helpful when seeking the maximum total return.

Just how good are Richie's returns? To put it simply, Richie is one of the premier growth stock investors of the last 20 years. If you invested in his fund when it began on October 24, 1983 and held it through year-end 2003, you would have a 1,440.49 percent total return on your investment, an annualized equivalent return of 14.5 percent. Over the same time period (beginning November 1, 1983), the S&P 500 index advanced 1069.22 percent, while the average fund competitor was up only 724.21 percent, or 11.03 percent on an annualized basis. Richie outperformed every peer. Additionally, he is ranked in the top 1 percent of his peers over the past five and ten years. Factor in risk-adjusted returns and he looks even better.

Ranked as the best in his category, Richie is the first to admit that you can't rest on your laurels; that's the time, he says, to give up management of the fund. His measure of success is his ability to make his investors money, not simply beating an index or competitor; in fact, he likes to see other managers do well because he likes to see all investors do well. He deplores the constant, daily measuring of one manager's performance against another's. "I just want to be the best I can for my investors; I never look at success in terms of me being in the top quartile or top 1 percent."

What has changed over the couple of decades he has been managing the Smith Barney Aggressive Growth Fund? Not much: His winning investing style, developed early in his career, is placing him at the top of the large-cap growth fund managers category; he still watches the ticker tape (though now it scrolls across a computer monitor); and he follows baseball as enthusiastically as he did as a child.

But some things *do* change: He no longer hates the fact that markets are closed on the weekends, he concedes with a smile. "That's when I get to spend time with my wife and two daughters.

Getting to know Richie means understanding his true loves in life. Besides family, and the markets, he is still passionate about baseball. And while he may fret that he will never play in the majors, today he is an all-star mutual fund manager, batting far better than any other large-cap growth fund manager around, according to *Winner's Circle* research.