MANU DAFTARY

DG Capital Management

When Manu Daftary arrived in the United States from his native India in the 1980s, he never imagined he'd one day be overseeing huge sums of money. After several years of analyzing and selecting investment managers to run college endowments, Daftary was handed a stock portfolio to run on his own. Since he had long observed the styles and techniques of the country's leading money managers, he brought what he considered to be their best practices together in forming the foundation of an investment strategy he continues to follow today.

Daftary, 47, ultimately started his own investment firm in Boston in 1996. He is also subadvisor to the top-performing Quaker Aggressive

Growth Fund. Daftary's core beliefs are that earnings drive stock prices, companies with earnings surprises tend to outperform the general market, and avoiding downside volatility is the key to long-term outperformance.

Daftary is an opportunistic investor and enjoys wide discretion when it comes to running his fund. For instance, he is allowed to raise as much cash as he wants, is free to buy companies of all sizes, and can even short stocks as he sees fit. As a result, Quaker Aggressive Growth is often compared to a hedge fund, since it's definitely not for the faint of heart.

As you'll learn, Daftary looks at stocks through a variety of glasses. When it comes to analyzing bigger companies, valuation is of utmost importance. For the smaller names, value is important, but earnings momentum is king. Above all, diversification is crucial since, as Daftary puts it, despite your best efforts, you never truly know which stocks will become your biggest winners.

Kazanjian: *I know you grew up in Bombay, India. What originally brought you to the United States?*

Daftary: When I graduated from college in India, there wasn't much opportunity there other than joining the family business and I really didn't want to do that. The MBA programs in India were very underdeveloped, so I decided to go overseas to study. I had the choice of going to either London or the United States. My brother was at Long Beach State in California and suggested I apply there. I redid my bachelor's in business and then entered the MBA program at Long Beach State. Quite honestly, it wasn't a great school and I was bored. So before completing my MBA, I applied to a blind ad asking for a financial analyst, assuming it was something related to cost accounting. It turned out to be a position at Cal Tech helping to run the school's endowment program. I got the job and came in as a trainee. At Cal Tech I learned the ropes of the investment business, and ultimately finished my MBA while working there.

Kazanjian: *Were you picking stocks at Cal Tech?*

Daftary: No. I did plan sponsor work, which included asset allocation studies and the hiring and selecting of managers to run the money. By 1983, I thought about moving on, and considered relocating to New York, since there really wasn't much of an investment community in Los Angeles. I was packing my bags one day and saw an ad in the *Wall Street Journal* from the University of Southern California looking for someone with my capabilities. I interviewed with the treasurer of the university who was very dynamic and I liked her right away. She called me following the interview and said I was hired. I was still planning to leave for New York, but she persuaded me to come in as the number-two person there. I worked with her for three years on the same sort of plan sponsor projects, picking managers and such.

Kazanjian: *When did you actually get to start managing money yourself?*

Daftary: In 1985. That year, the treasurer of USC got approval to actually manage a stock portfolio internally, instead of just farming it out to other managers. Once we got the approval, she gave me the portfolio to manage. I didn't have to work with committees or anyone else. It was really great.

Kazanjian: *How did you go about choosing stocks, given that this was all new to you?*

Daftary: I was learning on the job. The funny thing is I had spent three years at USC thinking a lot about stocks because I was interviewing managers to run money for the university. In that process, I was learning about how to pick stocks from very smart people. We liked to hire managers who were just starting out. Many had left larger management firms and were young and hungry. A lot of them are still friends today. But when I took over the portfolio, I knew the first thing I needed was a Quotron machine. We didn't have one in the office. Then I had to worry about getting accounting systems and establishing relationships with brokers. Since we had none, I called up USC's alumni office and asked whether they had any graduates who had gone on to become brokers. We found three. It was a real bootstrap operation. When I started my own firm in 1996, it was truly my second startup. At USC, we started out managing around $5 or $10 million. That was up to $200 million by the time I left. And we did it all with a very skeletal staff. I had only two assistants.

Kazanjian: *You left USC in 1988 and worked at two other firms before going out on your own in 1996. What made you ultimately start your own company?*

Daftary: In 1996, I was recruited to help run an investment firm in Boston. But it was clear that the gentleman who brought me in to take it over was never going to leave. Personality-wise we just didn't get along. About a year and a half into the job I decided I had to get out of there. At that point, an old friend of mine called. Jeff King, who had started the Quaker family of funds, said to me, "You're very unemployable right now. You need to go out on your own." He knew I wanted to do it and really egged me on to make that move. He had enough faith in me to hire me to start the Quaker Aggressive Growth Fund, even though I didn't have a track record. But the question was how to raise money. Jeff took me around and I was able to raise about $7 million from an offshore investor as seed money for a hedge fund. So I left my job and started the firm, without much in hand. There was a lot of panic at first, but I felt I didn't have any choice. For the first two years, it was hard growing the firm because we didn't have a track record. Plus, the $7 million we had was hedge fund money with high expectations that could leave any day.

Kazanjian: *When did the Quaker Aggressive Growth Fund start?*

Daftary: DG Capital, my firm, was incorporated in July 1996 to manage hedge fund money initially. The Quaker Aggressive Growth Fund began operations in November of the same year.

Kazanjian: *Your firm now runs about $650 million. That's some pretty good growth.*

Daftary: Yes. A little more than half of that is in the Quaker mutual fund. The rest of the money is run for institutional clients like endowments and foundations.

Kazanjian: *When it comes to managing money, you seem to have a go-anywhere investment approach.*

Daftary: I've always felt that a big problem in the industry is that there is a lot of compartmentalization going on, where managers are hired by plan sponsors for a very specific reason.

Kazanjian: *You mean to specifically buy growth or value stocks and the like?*

Daftary: Growth, value, small-cap, mid-cap—I philosophically have never believed in that. I feel that a money manager who is on the leading edge of everything that happens in the stock market should be given all flexibility to adjust the profile of the portfolio based on an evaluation of the risk level of the overall market. Even back in the 1980s, I felt that a lot of plan sponsors didn't realize the risk that they were taking in hiring certain managers because they didn't understand the risk level. They just saw the returns. They said, "Okay, we see the returns, and know you have higher risk, but we'll put you in this efficient portfolio and it will all work out." That looks great on paper, but in reality it just does not work over time. Our philosophy as managers is you should enable us to evaluate what risk to take for the assets we are managing, in our case stocks. In order to do so, you basically have to be a multicap manager and have an opportunistic approach.

Kazanjian: *So you have the freedom to buy anything you like?*

Daftary: Yes. We will go where we think it's necessary based on the risk that we need to take. That is the philosophy. We won't be typecast. The bottom line for all managers is that you have to beat the S&P or you'll be fired. It's interesting. When I started managing money, all I knew was Graham and Dodd and Warren Buffett. I had just read *The Intelligent Investor* and John Templeton was an idol. So I was really a value manager back in the 1980s. As we diversified the portfolio at USC, we realized we needed to run some of the money as growth. When I looked at the growth sector, I realized that earnings drive stock prices over time and if earnings go up, stocks go up. The problem I had with the growth universe was that it tended to be extremely volatile, especially on the downside. Given that growth managers tended to underperform over time, I wondered why one would hire people in this area. My belief was that the only way you can effectively manage money in the growth area is by avoiding disasters.

Most growth managers are very good stock pickers. Unfortunately they tend to have a lot of blowups in the portfolio, which really kills the performance. The reason they have all these blowups is twofold: First, the U.S. equity markets are mostly value-oriented, because the economy only grows 2 to 3 percent over time. Second, it's very difficult to find a classic growth stock, and when growth managers spot it, they all jam into the stock together. When the trend reverses, they all blow up together. That's the reason the whole growth sector goes out of favor.

I believe the only way you can outperform in the growth universe is to avoid negative surprises and downside volatility. If you go down 40 percent, you must go up 67 percent to break even again. If you can truncate the downside, you'll have all the money to play on the upside, which is where all the money is made in the stock market.

Kazanjian: *That's an admirable goal, but how do you achieve it?*

Daftary: We are very concerned about buying companies that could have negative earning surprises. We actually spend more time making sure we avoid the losers than finding the winners. We put great care into figuring out supply–demand characteristics, meaning that we avoid stocks where there are a large number of institutional owners of the stock who will most likely be sellers over time. We want to be very early investors in our companies. I should also point out that we look at large-caps differently than mid-caps and small-caps. Large-caps tend to be more efficient, meaning that everyone is looking at and following them.

Kazanjian: *Do you take a look at the market and other macroeconomic factors when making this evaluation?*

Daftary: Yes. We look at what's going on in the overall economy. One really has no choice, especially if you're a growth manager. For example, we pay close attention to interest rates. We also look at money flows, meaning we want to know whether dollars are going into the market or not. That's a supply-demand characteristic we monitor. The direction of the dollar is important, especially for large-caps with sales overseas. We also look at valuations. For example, in early 2004 I told clients we were getting negative on small- and mid-cap stocks because their valuations were unsustainable, especially if interest rates kept going higher. We look at overall valuations for the various sectors as well.

I've always said that you can be the biggest crackerjack analyst, but after doing all your work on the company, will people care about it? We want to look at stocks people care about. The only reason people care about stocks is because they're either going to blow their earnings numbers away or they're totally undiscovered and will eventually be owned by others.

Kazanjian: *You're also not afraid to raise cash when you're negative on the market. In 2000, your fund had 80 percent of its portfolio parked in cash. What led you to make that tactical decision?*

Daftary: It wasn't an instant decision. Back in 1998 we had the Russian crisis, the global financial markets were getting killed, and everyone was extremely negative. Luckily for us, in the summer of that year we had raised cash and avoided the severe market decline that had occurred. However, by the end of that year, we began to buy companies that were growing 25 to 30 percent a year, especially in the technology area, but which traded at 10 to 11 times earnings. So we were very early back in October 1996 to take positions in companies that did extremely well in 1999. By the summer of 1999, however, we raised the cash level up to 40 percent. Some of the companies we had bought at 10 to 12 times earnings were now trading at 40 times earnings. I get very concerned when stocks are trading at 30 to 40 times earnings, regardless of what the growth rate is. That's when your risk really starts to ratchet up. While we moved back into the market in September 1999, by February 2000, the same thing started happening again. We had stocks going up 10 to 15 percent a day. I know from past experience that money doesn't grow on trees. When they start doing this, you know there's a problem. We started raising cash into February and March, which is why the cash level got so high. When you see

IPOs doubling and tripling on a daily basis, you have to stop and see what's going on. We did not get caught up in the fever of that time. People call this market timing. I say it's risk control. I like being invested. In fact, I think most of the money is made in the market on the long side (being fully invested), not by making these tactical moves that can mess you up mentally. I'd rather be fully invested. The problem is there are certain periods of time where that's not prudent.

Kazanjian: *Eventually you were right, but you were a bit early on the move to cash.*

Daftary: Yes, and I kind of wish we had moved into some of the more value-oriented stocks, instead of selling out altogether. I didn't realize how effective Greenspan would be in cutting rates and pumping up consumers. I wish I had owned more consumer and housing stocks back then.

Kazanjian: *Given the tremendous latitude when putting your portfolios together, how do you begin the process of finding individual stocks?*

Daftary: We're really opportunistic in our stock selection. We get ideas from all over. Given that we're multicap in focus, we can look at many ideas. As I previously noted, we look at large-caps differently than small-caps and mid-caps. Most of our performance attribution over time has come from our mid- to small-cap ideas, because that's where you get your triples and quadruples. On the other had, we have very modest expectations for our large-cap ideas. While we don't think we add any long-term value by investing in IBM, there are certain points in time when IBM, on a risk-adjusted basis, can give you 15 to 20 percent rates of return.

Kazanjian: *So let's start there. Where do you find, and how do you evaluate, your large-cap ideas?*

Daftary: We do screens to see what looks reasonable in this space on a valuation basis. We rely on information from Wall Street for the large-cap names. We talk to specific analysts on a company and look at earnings estimates. For large-caps, we let the Street do the work for us. We don't need to do primary research on these companies. In the large-cap space, we like to buy companies that are out of favor. We realize that when you start buying momentum, you're really playing with fire. There's no downside protection if you buy a stock that's run up 40 to 50 percent and the multiple's expanded but nothing else has changed. We want to own large-cap stocks that have come down to a reasonable historical valuation. We then check the cash flows and balance sheet. If we can buy something at 12 to 13 times forward earnings with a dividend yield, it probably makes sense to own it. Even though valuation is important, these are classic growth stocks we're looking for, meaning we're not buying aluminum or iron ore. We want companies with a very high ROE (return on equity), good growth characteristics, good cash flows, and a good management team in place.

Kazanjian: *In other words, you want to snatch up growth stocks when they hit a trouble patch.*

Daftary: That's a great way to look at it. I do believe that over time large-cap growth managers don't tend to add much value because it's a very efficient market. They tend to buy momentum and ultimately blow up. That's why we want to own those classic growth stocks when they come down to a reasonable valuation because of a temporary glitch.

Kazanjian: *The trick is making sure the glitch is only temporary.*

Daftary: That's why we don't get into what we call a "value trap." A very recent example of a value trap, in my opinion, is Tenet Healthcare. Tenet's stock is under a lot of pressure. A lot of value managers own it because they think it's got a good franchise. Yet the balance sheet keeps deteriorating, the CFO resigned, and earnings keep blowing up. The value guys keep buying on the way down because they think it looks cheap. It's a value trap because the company doesn't have a catalyst in place. Sure, it looks cheap, but the earnings aren't there anymore because of all the bad debts. We won't buy a company like Tenet until there's a catalyst and maybe some inflection point on the horizon. We're looking for companies with a potential earnings surprise coming out in the next two quarters. That is very important for us. And perhaps also a management change. That's what happened to Tyco. As soon as they hired a new CEO, the stock started outperforming. We don't want to be buying a stock just because it's going down and it looks cheap. That is a no-no for us. I always say you find one cockroach in your room, you'll find another one.

Kazanjian: *How is your analysis different for small- and mid-cap stocks, and where do you find these companies?*

Daftary: Those stocks tend to move more on earnings momentum. We find them from many sources. We do run earnings surprise screens internally. We scan to see if there's anything interesting. But it's rare to find a good company just by doing a screen. We go to investment conferences to find out what's going on. We go to trade shows. We have a person here who goes to a lot of technology trade shows to test the latest gadgets. And we see companies one on one. Boston is a good place to be, just like San Francisco and New York, since a lot of management teams come through town. The management teams give you a bit of color on the company and sector. We take that information and generate an earnings model and a balance sheet model, and do some additional primary research on the companies. We then talk to contacts in the industry to find out what's going on. The information you get is somewhat random, but when you start digging into a company, you keep digging and digging until you find the pot of gold. We do a lot of digging around. We also talk to others in the investment business to see what they're looking at.

Kazanjian: *So once you've found an idea, what's the deciding factor on whether you buy the stock?*

Daftary: Once we get the information or we've seen the company, we prepare an income statement. If there is no analyst on the Street or regional brokerage firm that follows the company, we'll also do a primary research report. We then do an earnings estimate going out for the next year and come up with a number. Let's say we have a company trading at 15 times earnings with really good cash flow. We'll then look at the demand–supply characteristics of the stock to check whether other institutions own it. If it's not followed very well, that makes us even more interested because we know money tends to eventually gravitate to companies that perform well. If the stock is cheap now, over time the big guys will find it. Once this work is done and everything looks good, we will start buying. In some cases, we will take a minor position in the beginning, and then wait for more of our valuation thesis to occur before buying more. If, on the other hand, the earnings of a company fail to meet our expectations, it is gone. We are very, very ruthless. Then we say, "Shame on us! It was our fault because we messed up on the earnings forecast and therefore did sloppy work."

Kazanjian: *It almost sounds like your approach for small- and mid-caps is the exact opposite of your approach for large-cap stocks. You're trying to buy the small names as they go up, and the bigger ones on the way down.*

Daftary: It's true. The reason is that in the small- and mid-cap space, these companies tend to be more one-product specific, and the news tends to get better as the market share gets bigger for the company. The earnings that we project out tend to be very conservative compared to what the company usually does. If they're on a roll, they can really get going and beat the numbers, to where momentum buyers start moving in. You have to be more of a momentum player in this space. Still, the best thing is to be a little more proactive and buy these stocks when prices are coming down and hopefully add more as people start getting excited about it.

Kazanjian: *You said you sell the smaller stocks when they don't meet earnings expectations. What are some other reasons to pull the trigger?*

Daftary: Valuation is one. Stock returns are based on earnings growth and multiple expansion. Sometimes a stock goes up because its multiple expands and people get more excited about it. If the earnings don't go up as the multiple expands and the target price doesn't change, we'll sell when it hits our target price. Clearly if the company disappoints us, we'll also sell. The third reason is if we get a little concerned about earnings going forward, maybe because the economy doesn't look great. If the outlook gets too bad, we may even think of shorting the stock.

Kazanjian: *Speaking of which, unlike most fund managers, you have the freedom to short stocks in your portfolio. How do you find ideas to short, and when do you decide to follow this course of action?*

Daftary: Shorting is one of the most difficult investment processes around. Generally people don't like to short, so you're kind of trying to swim upstream most of the time. The short side is really the reverse of the long side. All we're doing on the short side is looking for potential earnings disappointments. We're looking for companies on the short side with fundamental problems and balance sheet deterioration. A lot of growth managers spend time on income statements, earnings, margins, and all that stuff. But if a company is just making its numbers by deteriorating the balance sheet, which happens frequently, you can really get into trouble. Balance sheets tell you a lot. They tell you whether receivables have gone up too much and whether this could be a real problem for earnings going forward. The process really is reversed on the short side. If we figure out that a company is going to miss its numbers, or know the estimates are coming down while the valuation looks expensive, we get very interested. The problem with many of these high expectation stocks is they're so expensive, even when they miss estimates and get cut by 30 percent, they still look expensive. People get frozen and wait to keep selling. Therefore, we look for situations to short where we think the supply available to sell could be greater than the demand as more people start getting out.

Kazanjian: *Shorting can be quite costly when you're wrong. At what point do you decide to cover shorts that go the wrong way for you?*

Daftary: We have a stop-loss for 15 to 20 percent on the other side. You've got to be quick on that, because stocks are volatile and can go right through that level in no time.

Kazanjian: *What's the highest percentage of your portfolio you'll short?*

Daftary: In the mutual fund we have a 25 percent restriction. Over the history of the fund, our shorts have on average been in the 7 to 8 percent range.

Kazanjian: *Have you done analysis to see whether the shorts have actually enhanced your fund's performance over time?*

Daftary: A lot of clients ask for that. In 2003 the shorts hurt us. But over longer periods, we have actually made money. I look at short selling really for two reasons. The most important is to make money. The second is to hedge my long positions. But that's not as important as trying to make money.

Kazanjian: *Shorting stocks can be very tricky. Do you recommend that individuals try this approach for their own portfolios?*

Daftary: No. I would say that individuals have to be very careful. Most individual investors try to do conceptual shorts. That is the kiss of death. In other words, they say, "I think eBay is expensive, so I'm going to short it." The logical question is, "Why is it expensive?" Unless there is a fundamental reason the stock is likely to miss a number and the supply and demand characteristics are adverse, you should avoid shorting.

Kazanjian: *Back to the long side, is there a set percentage of the portfolio you like to keep in large-caps, versus small- and mid-caps?*

Daftary: We really do believe in building the portfolio from the bottom up. The way the weightings get into the portfolio is really based on the best ideas being generated and put in there. The market weightings fall into place based on the stocks that we're buying.

Kazanjian: *How many stocks do you tend to own?*

Daftary: Anywhere from 40 to 75, depending on whether we're more heavily in small- and mid-caps or large-caps. For large-cap names, we'll take up to a 5 percent position. We won't go that high for smaller stocks. One reason for diversification is that out of 10 growth stocks, six tend to blow up, according to a study done by an ex-boss of mine. Therefore, I don't believe that growth managers should own 20 names. They should own 40 to 50 names. You don't know which stocks will be the ultimate winners. The random stock that goes up 100 or more percent is just that: random. It's pure luck.

Kazanjian: *You have said before that you felt the United States was the best place in the world for people to invest their money. Of course, we have some international* *managers in this book who would disagree. But do you believe people in the United States should own any foreign securities?*

Daftary: No, I don't. Remember, I come from India, so sometimes you have to listen to the natives, right? Maybe back in the 1970s there was a noncorrelation with the world markets. But the world has become a lot smaller now and the correlations are a lot higher. If that's the case, one of the main foundations of the argument for investing overseas is gone. Second, people don't realize the risks you have in these overseas markets, including political risks. While I was a little shaken after September 11, I've always said that the United States has great natural resources and a great defense system. As a result, I feel there should be a premium for investing here. I still believe that. There's also fraud in many of these international markets. I don't own any international stocks.

Kazanjian: *What are your overall expectations for the U.S. market over the next several years?*

Daftary: Over time, I still think 7 to 10 percent annualized rates of return are feasible. I do think investor expectations remain too high. People are expecting 20 percent rates of return. You're not going to get them. I think the thing to pay attention to over time is risk. Not losing your money is going to be very important going forward.

One reason Daftary believes risk management is so important now is because we haven't had a true systemic recession since the early 1990s. Sure, things have been tough economically for the last few years, but it has been nothing like some of the downturns of the past. That's why Daftary feels his flexible style is such an advantage. It allows him to adjust to the current economic environment, be it by raising cash, switching more heavily into lower valuation securities, or even shorting stocks to profit from a potential decline in the overall market.