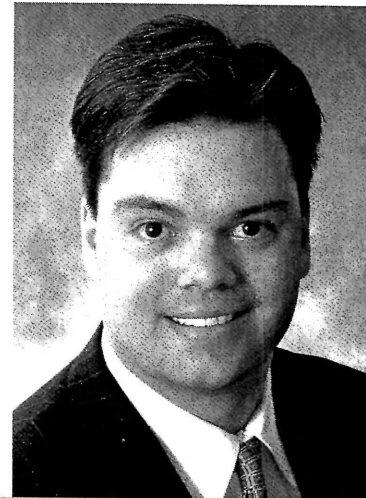




# Buying Blue Chips at Blue-Light Prices

John C. Thompson makes money the newfangled way: he's a growth-stock manager who pays considerable attention to valuation. And while many fund managers profess to be doing just that during this challenging period, John's success has been exceptional. His Thompson Plumb Growth Fund (800-999-0887; no load) continues to show positive annualized returns over the past three and five years, and this month earns a place for the 21st time in the past 36 months in the Long-Term-Growth sector of The Rukeyser 100. No surprise, then, that since I interviewed him on television in November 2001 (an interval that has scarcely been the happiest time for the mutual-fund industry), his fund's assets have increased from \$208 million to \$512 million.

John comes by his expertise naturally: his father, John W. Thompson, is the firm's president. But young John (he's still just 34) has shone in his own right. He has been picking most of the stocks for Thompson Plumb Growth since 1995, soon after receiving his MBA from the University of Chicago, and the fund is now very much his baby. A dedicated contrarian, he's a "go-anywhere" type of manager who searches for out-of-favor high-quality companies. That means he will occasionally take it on the chin, as he acknowledges below, but his long-term record for patient investors is compelling.—LR



**John C. Thompson: "When you buy high-quality companies at the lower end of their historical P/Es, you do very well."**

**John, your fund is one of the strongest long-term performers in the business, but even you lost 20.42% last year—your first losing year. Do you believe that we have entered a darker future for investors?**

Actually, to the contrary, Lou. We think the market has swung from extreme overvaluation a few years ago to maybe being fairly valued in early 2002 to now becoming undervalued—and therefore should provide investors very attractive long-term performance results.

**Can you quantify how you think it's undervalued?**

If we just look at such major stocks as General Electric, Microsoft and Pfizer, their price/earnings ratios [P/Es] are all at the lower ends of their historical ranges going back 15 or 20 years. And usually when you buy high-quality companies at the lower end of their historical P/Es, you do very well. You do better than their actual earnings growth, because you'll get the earnings growth plus P/E

expansion. So we feel that on some of the top companies, an investor could earn 12% to 15% over time.

**Do you agree with the view that the market is on hold until the geopolitical situation is resolved?**

I do believe the market will rally once something happens, but we tend to take a longer-term view. Our main worry is not geopolitical, but the overall level of debt within the economy—government, corporate and individual—amounting in total to something like three times our Gross Domestic Product.

**One of the things that hurt you last year was the same thing that has helped you so much in the past. You're a true contrarian investor. And the market didn't agree with some of your against-the-grain calls. Have you changed any of those calls?**

Yes, Lou, we have. One was Qwest Communications International, which really hurt us last year. We have sold the entire position. We lost half our

money in the stock. It was definitely a painful summer. Qwest's debt level made the stock extremely volatile, and with the valuation of all the Baby Bells dropping because of the competition in the local area, that definitely changed the valuation of that company.

AOL Time Warner was another major disappointment. We bought it in early 2002, but because of problems with the AOL unit and the company's high debt level, the stock dropped significantly. We still own it, however. In AOL's case, we think the debt is manageable and the assets not only are valuable but should be more valuable in two, three, four, five years.

**How do you pick stocks for the fund?**

Our overall thesis is that the investment community tends to make the mistake of extrapolating current business conditions far into the future and then valuing stocks based on those projections. So when a company is having a difficult year or two, its stock

tends to sell at an unduly low valuation; conversely, when business conditions are good, the stock tends to get an extremely high valuation. We try to work with that in an opposite fashion. We buy when companies are having maybe a year or two of tough times—it gets the valuation down—and then sell after they correct the situation and the valuation gets higher.

### By your tests, what are your most attractive holdings at present prices?

Let's start with our top two holdings: *Pfizer* and *Microsoft*. Pfizer is selling at 16 times 2003 earnings estimates; its P/E has ranged from 55-60 at its peak two or three years ago to a trough of 14 when the Clintons were bashing the drug sector in the early 1990s. So we're very close to the historical low. And with interest rates now as low as they've been in 40 years, that should actually create a higher P/E for a stock like Pfizer. The company has a great pipeline, the best in the business, and the merger with Pharmacia should create synergies and savings. Pfizer could grow its earnings 12% to 15% annually for three to five years, and its P/E could rise substantially.

Microsoft was a big holding in late 2001, when we last spoke. It's still a big holding. With \$10 a share in cash and investments, and earnings around \$2, Microsoft's real P/E—adjusting for the cash—is only about 18. That looks far undervalued, given Microsoft's near-monopolistic control of its market. And since the last major PC upgrade cycle was back in 1999, we're looking for a massive new upgrade cycle in the next year or two that should really help Microsoft.

Our third-biggest holding, in contrast, is our most recent new purchase: *Coca-Cola*. We've just taken on a very large position in Coke—from nothing three months ago. It's almost 5% of the fund. At 21 times 2003 estimates, Coke is near a historically low valuation; it has had about

five years of subpar earnings growth. There are a couple of reasons: the stronger dollar subtracted something like 6% or 7% per year from Coke's earnings growth (the company gets 75% of its sales from overseas) and since Coke had sold most of its bottlers, it was no longer able to take gains from that kind of sales. Now, with a dollar that's starting to fall, Coke could reaccelerate and start growing in the 10% to 15% range for three to five years.

Coke has pushed *Fannie Mae* into fourth place in our portfolio, but we still like Fannie. We've owned it off and on for 10 years; we didn't own it for about a year and a half when it got above 20 times earnings. It's a financial, and financials always sell at lower multiples. So while we were selling Fannie Mae at 20 times earnings, we were buying Coke at 21 times. We look at each stock's individual history to determine where to buy it and sell it. Right now, Fannie Mae is trading at about nine times 2003 estimates, which we think is too low.

And, finally, Lou, another of our top-10 holdings that looks particularly attractive now is *Cincinnati Financial*, a property-casualty insurance company reporting revenue growth of 16% to 17% because of firmer prices now in the insurance business, with a very solid balance sheet. This company is run somewhat like Berkshire Hathaway in that it uses stocks as its major investment. Insurance companies have the choice between emphasizing bonds and writing a lot more insurance, or emphasizing stocks but being unable to write as much insurance. Cincinnati has done a remarkably good job of running its investment portfolio over the past 20 years. Its book value has compounded at something like 18%—

### IN JOHN'S SHOPPING CART

Stock (Symbol)	Recent Price	52-week High/Low	Earnings per share* 2002/2003
Pfizer (PFE)	\$28.75	\$41.90/\$25.13	\$1.59/\$1.81
Microsoft (MSFT)†	46.44	65.00/41.41	1.84/2.02
Coca-Cola (KO)	39.00	57.91/38.85	1.77*/1.93
Fannie Mae (FNM)	63.00	84.10/58.85	6.31/7.12
Cincinnati Financial (CINF)	34.82	47.30/32.43	1.84/2.00
General Electric (GE)	22.50	41.84/21.40	1.51/1.61

\*Consensus estimates. †Fiscal years end in June. Source: Bloomberg, Zacks, companies.

and it's selling at book value right now, with a 3% dividend and expected 2004 earnings of \$2.

### You've talked about some of your sales. What is your average holding period, and what does make you decide to sell a stock?

Our average holding period is about two years. What makes us decide to sell is when the valuation rises to a point where we think there are better opportunities—or we think we're going to lose money in that stock.

### What are you looking for in the overall economy?

Subdued growth, for many years, because of the debt overhang I talked about earlier.

### What's a reasonable expectation for investors over the next year or two?

You could have a significant bounce in some of the biggest and best blue chips, such as those I've just recommended. And, Lou, I would include *General Electric*: everybody loved it at 60, and now they hate it in the low 20s—it's an amazing business we're in!—but GE is on a strong recovery path, and we think it's conservatively worth \$30.

### Finally, John, what's your single best piece of advice for mutual-fund investors over the next 12 months?

I would sell bond funds and buy stock funds. ▲

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