GARP Research

Crossing Over

Former Portfolio Managers Find Success on the Other Side

BY MEGHAN LEERSKOV

Growth at a reasonable price (GARP) requires consistency, patience and some common sense. A tempered blend between growth and value, GARP avoids the troubled and undervalued just as it does the high-fliers. And while practitioners of GARP might be thought of as traditional, GARP Research Corp. is anything but.

A subscriber to GARP philosophy, William W. Baker founded the firm seven years ago to provide independent equity research to institutional clients. Having spent 17 years performing investment research at the helm of several successful funds, Baker knew what portfolio managers were looking for. "Nine out of 10 people who start their own firms come from the sell side," he says. "I have spent my career on the buy side. Coming from the same place as my clients gives me some invaluable insight."

GARP Research currently has five investment professionals focusing on smid-cap ideas for its 50 institutional clients. The firm also recently became a broker-dealer, which Baker says has transformed the way it does business. "Before, we were analysts that did marketing on the side. Becoming a broker-dealer has allowed us to hire experienced sales people and we are really making over the business to see our clients and engage them in conference calls. We are stepping up our face time with clients." GARP is also a member of the Investorside Research Association, which certifies that members have no investment banking conflicts.

GARP Research focuses on quality not quantity, adding only 12 to 15 new names to its coverage universe each year. "That is roughly one new name per month with four analysts working on it — just do the math — that is a lot of time devoted to a company," says Analyst Seth Moshman.

In fact, GARP's research product is meticulous when weighed against comparable firms. Company reports routinely number 20 or 30 pages, and that's not counting the pages featuring models and charts. "We do really in-depth notes that discuss the relevant competitors and the warts of the companies," says Baker. "One of the things that frustrated me on the buy side is that I would read a report that advocates a company and then I would be trying to figure out why the stock is down 50% and why only one competitor is mentioned." He continues, "Then you dig in and read five more reports and call some people and find out the competitor is better than the company that you originally read about."

For this reason, Baker approaches research with an all-inclusive attitude. "We like to discuss all the details. We are trying to get everything in front of the portfolio manager that he would do himself if he were taking a month to research a company so that he can turn to our report and know he's getting the full story. We do this in an unbiased, open fashion and we find a lot of people appreciate that."

The firm also makes a point to keep "maintenance research" to a minimum. It does put out company updates frequently, but only when something significant has occurred. "We don't want to be news repeaters like so much of the research out there," says Baker.

Moshman insists that it is GARP's philosophy that sets them apart from competitors. "We approach our research from the perspective of a portfolio manager and look for companies that fit the stricture of our philosophy across many different industries," he says. Analysts at GARP have wide buy- and sell-side experience encompassing an expanse of industries. Baker agrees that they are generalists at heart who simply stick to finding stable companies with organic growth.

The firm favors quality companies that operate in a niche and are either part of an oligopoly or in a fragmented busi-

GARP Research Corporation

AT A GLANCE
Founded: 1995
Research Director: William W. Baker
Number of Analysts: 4
Companies Covered: 60
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ness. "We like companies with a better business model that allows them to take share every year," says Baker. Most importantly, GARP Research looks for a high return on capital employed without a lot of "bricks and mortar" and modest operating working capital.

Baker controls risk by sticking to companies with reasonable valuation. He often has a contrarian approach and has the patience to wait to recommend companies a year or so after a recent disappointment. "We try to control risk by looking at stocks that are kind of washed out and we avoid momentum stocks," he says.

GARP diverges from the pack by sticking with its recommendations for prolonged periods of time. Ninety percent of companies on the recommended list stay there for three years. "That practice is antithetical to the big brokerages because they want to see a lot of turnover," he says. However, it has been working well for GARP. The firm has outperformed the S&P by a wide margin every year since it was founded. "We don't really stress this, but it is the outcome of having positive selection," says Baker. "Why does Warren Buffett beat other people in performance? Because he doesn't manage his investments like a day trader! We find a great company and we hold it."

GARP also puts its money where its mouth is. The firm manages a small "friends and family" fund, buying its own ideas with a one-week lag after institutional reports are published. The firm sells on the same basis, altering position size as needed. "The fund has also outperformed, but it is mostly family money and we don't market it," says Baker. "It is a vehicle for us to participate in our own recommendations. When we recommend a stock we are going to be talking about it for years. The fund isn't about getting in front of those recommendations."

Baker and his team have several companies that they currently like. They cite Invitrogen (IVGN) as a good example of the criteria they look for in a company. The biotechnology company makes kits that simplify and speed up gene cloning, expression and analysis. "We believe that this is a classic situation of someone operating in a fragmented space, having leadership and high margins, and not needing a lot of plant and equipment," says Baker. "They are so much larger than anyone else, so if you are a scientist with a new technology that you want to distribute, then Invitrogen is the obvious choice."

Baker believes that the company's market is a real high-growth area, despite some deceleration in recent years. GARP recommended the stock after the price had come down a bit and despite recent price rises, Baker still likes it. "They can make some acquisitions that will help, and they just made one that could increase earnings by 50 cents in a year, so maybe it isn't that bad that the stock ran up a little bit."

Recommended Delta and Pineland Co. (DLP) is the dominant supplier of cottonseed sold to farmers — seeds that result in higher-yield crops. Like Invitrogen, Delta dominates its market of distributing cottonseeds in the U.S. "Delta is basically being sought out by biotech firms to put new genomic content into seeds," says Baker. "Its royalty on that is going to rise dramatically because over 30 companies are approaching Delta." Baker also notes that Delta is suing Monsanto Co. (MON) and Pharmacia Corp. over a failed merger. "Delta could potentially gain $30 per share if they win the lawsuit," he says.

Baker also likes IDEXX Laboratories (IDXX), a producer of diagnostics primarily for veterinarians of companion animals. The company pioneered the concept of in-house testing at vet offices, such as heartworm and feline leukemia. "IDEXX is a predictable mid-teens EPS grower," he says. "The company is entering the drug business now and they have three new products to be released in two to three years." Baker expects that these drugs could help the company to be a 20% EPS grower.

Cabot Microelectronics Corp. (CCMP) is the world's top maker of slurries used in chemical mechanical planarization (CMP). CMP is a wafer polishing process that enables integrated circuit manufacturers to produce more complex devices. "Its revenues have been rising in the mid-teen rate during the downturn in tech and there is more growth ahead of them regardless of a tech rebound, but we do believe there is a rebound in the future," says Baker.

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