The Girton Capital Growth Letter

Discovering and Tracking Great Growth Franchises

March 23, 2012

Investing in Growth Stocks You Can Believe In!

In September 2011 we wrote a piece called *Total Return through Dividend Growth Stocks* in which we discussed how to benefit from a core portfolio of income plus dividend growth stocks. In this letter we focus on adding growth to portfolios by investing in sustainable growth stocks. We find original growth ideas by looking for an excellent product or service that is growing rapidly. We hope to spot a trend that is not a "flash in the pan" but one that may last for many years into the future. Some examples of these trends may be right in front of you. Perhaps you are reading this report on an Apple iPad. Maybe, like Alec Baldwin, you play *Words with Friends* while travelling. Or you may wonder who makes a new food product you like. From everyday life, and by studying stocks and the business world, we can find products or services that may be good investments at the right time.

By investing in excellent products that you use around your home or office, you can save resources and possibly find a good investment in the process. When we researched the water industry, we found that a PUR water filter could improve water quality while eliminating plastic bottles, and so we installed a water filter. In our last letter on LED lighting, our research resulted in the installation of energy-saving Cree and Phillips LED bulbs and fixtures around the house and office. We have also examined and invested in various renewable utilities in order to earn back the cost of our electric, water and telephone bills (and hopefully more).

We have investigated solar energy and electric cars, because we see ourselves and our clients owning these products as fossil fuels are inevitably replaced by electric power generation. We often write on the organic foods industry, and buy organic or natural foods and beverages to try them out. In addition, we have written on *Community Banks, Social Networking* and *Greener and Safer Dentistry.* Much of investing comes down to understanding the products and services you are using in your life, and investing *in what you believe in.* This means investing in a product or service that you think is making a *constructive* difference in the world, and by investing, you can share profitably in its success over time. In our opinion, it also means avoiding *destructive* products you would probably try to avoid in real life, such as tobacco, pollution-producing and weapons companies.

Evaluating Different Investing "Systems"

There are many different "systems" for investing including fundamental investing and technical investing. Fundamental investing studies economies, industries and companies, and compares competing companies' income growth and balance sheet strength. Fundamental investing is further divided into value investing and growth investing. Proponents of value investing often follow Warren Buffett, who in turn based his investing on the value investing classic *Security Analysis* by Graham and Dodd. Value investors focus on the company's balance sheet and they like to buy a company at a discount to book value or even a discount to net liquid assets.

Many proponents of growth investing model their investing off of Peter Lynch, the Fidelity Investments fund manager who wrote the growth investing classic, *One Up On Wall Street.* Growth investors invest based on prospects for the company's earnings growth over the long term. In our view, Lynch's greatest contribution to investment philosophy is to buy "what you know" and to buy stocks when the fundamental story is getting better, and to sell them when the fundamental story is getting worse.

As opposed to fundamental investing, technical investing is divided into chart readers and those who follow other technical indicators such as our favorite, money flow. Some of the famous technical analysts and traders over time include Jesse Livermore, who inspired the book *Reminiscences of a Stock Operator,* Stan Weinstein of *The Professional Tape Reader,* and William O'Neil, founder of *Investor's Business Daily,* who also wrote *How to Make Money in Stocks*. The latest investment system book, published in January 2012, is called *Buy High, Sell Higher*, by Joe Terranova. Of course, Terranova is cleverly modifying the original stock market motto of *Buy Low, Sell High.* Another famous aphorism many stock market strategists adopt is *cut your losses and let your profits run.* This strategy, which is central to technical analysis, is also a tax efficient strategy for taxable accounts.

The famous investment book *A Random Walk down Wall Street* by Burton Malkiel posits that stock market moves are random, making it impossible to predict when a stock or the market will go up or down. This is a reflection of Eugene Fama's *efficient market hypothesis* which says that all investments are fairly valued at any given time. Investments are fairly valued because millions of investors are buying and selling stocks every day based on the perceived value of the investment in the marketplace. However, just because investments are fairly valued today doesn't mean you can't make money in the stock market. History shows us that the stock market generally trends upward over time. From our experience, we think that certain smart, savvy and skilled people, such as Buffett or Lynch, can beat the market.

Our strategy is to work hard to find the winning investments to build capital over time. Once we find an emerging growth trend, we examine the industry surrounding that trend and identify what we believe are the best companies in that industry. We read everything we can find about the best companies in the industry. We look at things like strong leadership, great products, financial strength, and a competitive edge over other companies. We visit conferences in order to look at competitive products and we talk to product specialists. We also check the supply/demand picture of the stock (charting or technical analysis). But we spend most of our time thinking about the company's fundamental products or services and their growth and profitability since we believe that is what will move the stock higher. Then we can make an informed decision about the purchase of that investment.

Like Peter Lynch, we think the best way to make money over the long term is to find winning growth stocks that can return a multiple of two to ten times the original investment (two-baggers to ten-baggers as Lynch would say). And at the same time, we want to invest in beneficial trends such as social networking, positive medical devices, organic and natural foods, community banks, renewable utilities and alternative energy, since we see these as long term successful trends.

World Catches a Boost of Confidence

The US stock market has rallied 11% since the beginning of the year or from 1258 to 1397 on the S&P 500 index. Much of this appears to be due to a near-term resolution of the European debt crisis, particularly Greece. Greece received the backing of over 85% of its creditors to restructure its debt by writing off about 50% of its 200 billion Euros of debt. This is expected to substantially reduce Greece's Debt/GDP ratio to 120% from over 160%. At the same time, the European Central Bank (ECB) has lowered its main refinancing rate to 1% from levels of 3.75% last year, which is designed to stimulate its economy to ameliorate the effects of its 2012 recession. As can be seen from the chart on the next page, the Euro weakened to $1.27 from levels of almost $1.50 last year, and has recently been stabilizing around the "still weak" $1.30 per Euro level due to the Greek debt crisis resolution.

Euro in US Dollars – One Year

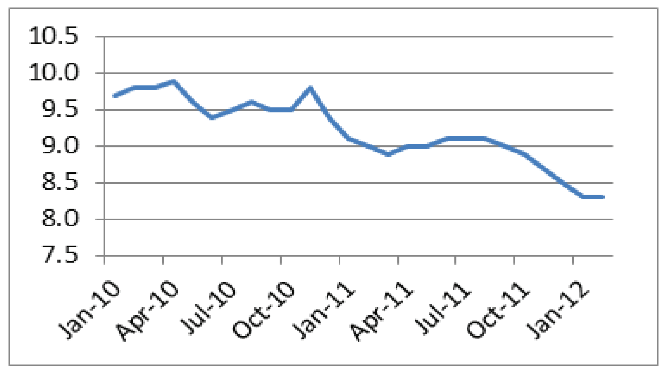
The Federal Reserve recently released its bank stress test and most of the major banks passed with the exception of Citigroup, Ally Financial, MetLife and SunTrust. As well, the FDIC is taking far fewer banks into receivership, as the rate of bank failures is slowing with three failures so far in March and four in February. This is in stark contrast to the FDIC seizing assets of about 10 to 20 banks per month during 2009-2010. The improvement in banks is highlighted by Union Bank's *premium offer to buy* Pacific Capital Bancorp of Santa Barbara for a substantial 2 times book value, increasing its footprint in the valuable California central coast region.

On March 7th, the Wall Street Journal (WSJ) reported that the Fed is considering a policy called "sterilized quantitative easing (QE)." This program could augment the Fed's current "operation twist" program in which the Fed sells short term securities and buys long term ones. However, in "sterilized" bond buying, according to the WSJ, "the Fed would print new money to buy long-term mortgage or Treasury bonds but effectively tie up that money by borrowing it back for short periods at low rates." In this way, the Fed hopes to avoid creating unwanted inflationary pressure. However, shortly after the WSJ story hit the press, 30 year treasury yields increased sharply from about 3.1% to 3.4%, perhaps an indication that the market believes another round of QE, even if "sterilized," would still be inflationary.

Speaking of inflation, gasoline prices have skyrocketed from $3.20 per gallon in December to $3.85 today ($4.30 in California – source, gasbuddy.com), becoming a political campaign issue in the process. The gasoline price increase has been driven by oil (West Texas Intermediate) increasing from about $80 per barrel last October to $106 per barrel today. However, the Commodity Food Price Index is down 10% over the past 12 months, with coffee down 20%, cocoa down 32% and cotton down a whopping 52% according to www.indexmundi.com. In addition, while the US housing market is improving, housing prices have not turned up substantially.

Both political parties of Congress appear to be on their best behavior, temporarily calling a truce on last year's period of obstructionism and even passing a jobs bill designed to help small businesses. The job market is improving, with 2.3 million jobs created in February, and the unemployment rate sinking to 8.3% nationally.

Unemployment Rate (in percent)
Seasonally adjusted



The question is whether the economic improvement and stock rally are sustainable over the longer term. Since US earnings estimates have declined slightly (see market update below), the early 2012 market rally has been entirely a rally of P/E expansion, rather than increased earnings estimates. In other words, it is a rally of confidence that earnings growth may occur over the 2012 to 2013 time frame as opposed to the earlier thinking of a double dip recession.

In summary, the market's impressive rally so far this year stems from a lack of a collapse in Europe plus stronger retail and consumer confidence trends in the United States. For the time being, we should enjoy this rally, with the caveat that things can change as we approach the presidential elections in November of 2012. We continue to invest in stocks *that we believe in* that we think are still undervalued and conversely, will look to sell stocks that have become overvalued.

Market Update and Valuation

Since December, the 2011 S&P 500 average of top-down (economists) and bottom-up (analysts) operating earnings was posted at **$96.42** down 1.5% from the estimate of $97.96. The 2012 estimate also decreased by 1.5% to **$104.92** from $106.58 and 2013 estimates were initiated at **$115.43**. With the S&P 500 now at 1,397, the P/E ratio to 2012 operating earnings estimates is 13.3 and to 2013 estimates is 12.1. Applying a 14 P/E to 2012 average estimated earnings targets the S&P 500 at 1,469 in the next year, up 5.2% from current levels. The risks to these forecasts include a double dip recession or higher than expected inflation (or deflation).

Portfolio Companies Update

Portfolio Actions: Since our last letter, we invested in two leading providers of ventricular assist devices (VADs), Thoratec and Heartware. We bought both companies since, while it is not certain which company will be the most successful, we expect that the *entire* VAD market will grow over time.

California Water Svc (CWT $18.23 – Div. 3.5%) is a leading water company with operations in California, Washington State, New Mexico and Hawaii. The company is regulated by the California Public Utilities Commission (among others) which has instituted a water revenue adjustment mechanism (WRAM) to help conserve water in the state. The company's earnings have recently been slowed by negative adjustments to the WRAM, but these are projected to be resolved in 2012. In the meantime, the company continues its water capital projects of over $100 million per year, and has raised dividends every year since 1968.

Heartware (HTWR $65.86 – Target $80+) is viewed by several analysts as the technology leader in ventricular assist devices versus the more established Thoratec (see below) The Heartware VAD device is smaller and according to some studies, has a higher survival rate than Thoratec, although like all VADs, is not risk-free. As a development stage company (with most revenues in Europe), Heartware is investing heavily in its technology and clinical trials and is thus losing money. Nevertheless, if it gets approval (or a path to approval) for its VAD in the United States in April, the company can increase its revenues rapidly and begin its MVAD (miniature VAD) studies later this year or in 2013.

Nuance (NUAN $25.81 – Target $37+) continues to grow organically and through acquisitions in four areas of digital speech: medical transcription, automotive, enterprise, and mobile. Nuance is thought to power Apple's *Siri* speech recognition, and may also power the dictation device on Apple's new third generation iPad. Nuance indicated on its latest conference call that it expects strong earnings in the second half of the year due to new products. The company is cash flow positive and non-GAAP earnings are estimated by the company at $1.55 to $1.62 per share in 2012.

Thoratec (THOR $33.75 – Target $40+) is the leading provider of ventricular assist devices (VADs) in the world. The company provided over 3,000 VADs to patients in 2011. In some cases, VADs improve a patient's quality of life from a bedridden stage IV heart patient to someone who can stand up and play tennis! The market for VADs and other devices, such as THOR's proposed percutaneous heart pump (PHP) to help stabilize heart patients, is advancing by about 10 to 15% per year. As VADs get better over time, we would expect to see continued growth in this market. See also the Heartware report above.

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