Small-Cap Growth Investing
The Power of Compound Growth

Jack Laporte
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The Power of Compound Growth

Case Study: Wal-Mart Stores

➢ New Horizons Fund and New Era Fund bought on the initial public offering in 1971.
   • Split-adjusted initial public offering price was $.0008 per share.

➢ New Era Fund still holds Wal-Mart Stores


➢ Earnings growth has been 25.1% per year over the last 25 years.

➢ The stock price has risen 28.8% per year over the last 25 years.

➢ A $10,000 investment in Wal-Mart Stores on the initial public offering would today be worth how much?

➢ New Horizons Fund held its maximum position in Wal-Mart in 1973-74. If the fund still held that position today, it would be worth how much?
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Case Study: Apollo Group

- A top holding of the New Horizons Fund
- Originally purchased by New Horizons Fund on December 1994 initial public offering.
  - Added to initial purchase around one year later.

- Sold 5% of holdings in 2001
- Sold 10% of holdings in 2002
- Sold 15% of holdings in 2003
- Sold 15% of holdings in 2005

- Initial purchase price of $0.72

- Today’s price $52.00

- 46% annualized rate of return over 11.25 years
  - 45% per year compound annual earnings growth

- Result- Over $200 million profit for New Horizons Fund’s shareholders!
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Case Study: T. Rowe Price

- Initial public offering on April 2, 1986 at $1.50 per share
  - Market cap following initial public offering was $168 Million

Fundamentals:

<table>
<thead>
<tr>
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<th>December 1985</th>
<th>December 2005</th>
<th>Compound Growth Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>AUM</td>
<td>$19.8 billion</td>
<td>$269.5 billion</td>
<td>13.9%</td>
</tr>
<tr>
<td>Revenues</td>
<td>$84 million</td>
<td>$1,512 million</td>
<td>15.5%</td>
</tr>
<tr>
<td>EPS</td>
<td>$.07 per share</td>
<td>$3.15 per share</td>
<td>21.0%</td>
</tr>
<tr>
<td>Price</td>
<td>$1.50 per share</td>
<td>$72.00 per share</td>
<td>21.4%</td>
</tr>
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- A $10,000 investment on the initial public offering was worth $480,000.00 as of today (excluding dividends).

- Dividend increased every year since 1986 IPO and now is and annualized $1.12 per share.
T ROWE PRICE GROUP INC (TROW)

PRICE 81.77 DATE 04-17-2006
StockVal®
New Horizons Fund All-Star Team

Apollo Group
Affiliated Computer Services
Analog Devices
  Davita
Henry Schein
Home Depot
Lin Broadcasting
Maxim Integrated Products
Medco Containment Services
  Molex
NII Holdings
Paychex
Wal-Mart Stores

Criteria for inclusion:
  ➢ Must have generated at least $100 Million of profits for fund shareholders

All-Star Team characteristics:
  ➢ Visionary, entrepreneurial CEO
  ➢ Unique, industry-changing business strategy
  ➢ Distinctive company culture
  ➢ Operate in massive, fragmented, mostly service industries
  ➢ High recurring revenues
  ➢ Outstanding ROE/ROIC
  ➢ Extraordinary, sustainable sales and earnings growth
  ➢ Strong cash flow/ability to finance majority of growth internally

All-Star Stock characteristics:
  ➢ Stocks almost always look very expensive using traditional P/E or PEG measures.
  ➢ Need to understand the power of high compounding earnings growth over the long-term.
  ➢ Need to avoid the temptation to trim/scale back positions.
  ➢ Average New Horizons Fund holding period of All Star Team is over 10 years.
Long-term 20% Annual Earnings Growth is Rarest Air

➢ Consistent high earnings per share growth is easy to predict but hard to achieve.

➢ Companies regularly fall short of their own and Wall Street’s earnings growth expectations.
  • Analysts predict 12-14% bottoms-up long-term earnings growth for corporate America.
  • Companies realize 6-8% long-term earnings growth.

➢ A Compustat universe of approximately 3,500 companies with positive earnings ten years ago showed that only 1% of the total (30 companies) grew their earnings at a 20% compound annual growth rate without a down year. Another 1½ % (52 companies) achieved a 20% growth rate but had one down year during the period.
  • Lowering the growth hurdle to 15%, only 132 companies (4% of the total) grew their earnings at a compound rate of 15% or more with no more than one down year.

➢ Investors tend to extrapolate the most recent favorable trends or assume a rapid turnaround following a downturn in business.
Small-Cap Growth Investing
We Can’t Afford to Miss the Big Winners

➤ The real money-makers are few and far between. We need to exploit as many of them as possible.

➤ Small growth companies either grow up or blow up.
  • The fallout rate in small growth companies is very high.
  • The laws of probability indicate that we will make our share of costly mistakes.
    ▪ When a small-cap growth companies goes off the tracks the stock gets destroyed.
  • Our job is to have as high a batting average as possible with our picks.
  • One big winner makes up for a lot of mistakes.
  • We obviously want to minimize our mistakes but we can’t keep the bat on our shoulders.

➤ We can’t afford to miss the big winners.

  • Starbucks-
    ▪ We knew it cold from its venture days when our Threshold Fund was an investor.
    ▪ New Horizons Fund bought a meaningful position on the initial public offering and owned it for two years.
    ▪ We sold it based on short-term concerns which were correct but we never bought it back.
    ▪ New Horizons Fund made $8 million on Starbucks but left over $200 million on the table.

  • Microsoft-
    ▪ New Horizons Fund bought it on the initial public offering in 1986 and sold our position in 1988, making less than $1 million.
    ▪ New Horizons Fund never bought Microsoft back.

➤ Analysts and portfolio managers consistently underestimate the long-term upside (and downside) stock price moves from winning (and losing) stocks.