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Staring down risk - and profiting

By Scott Medintz @FortuneMagazine January 16, 2014: 7:04 AM ET

Dennis Lynch has taken investors on a wild ride in recent years. When the market did poorly, his $2 billion Morgan Stanley Focus Growth Fund did even worse, crashing 52% in 2008. But when the market has done well, the portfolio has absolutely crushed it -- gaining 73% in 2009, and 49% in 2013, vs. 29% for the S&P 500. All told, investors who fastened their seatbelts are glad they did: Focus Growth has beaten the S&P 500 by nearly 10 percentage points a year since 2008. Lynch, 43, who oversees a total of $30 billion as the leader of Morgan Stanley Investment Management's growth team, says that kind of volatile trajectory is inevitable given his willingness to wait for long-term investments -- often in disruptive, paradigm-shifting companies -- to mature. *Fortune* asked him to explain his philosophy on riding out volatility and profiting from radical change. Edited excerpts:

The stock market had a great 2013, but your Focus Growth Fund way outperformed. What's your secret?

We really take a long-term view, which is something that's often talked about but hard to implement because of what Warren Buffett calls the institutional imperative -- the pressure that comes from being long term in a world that is short-term-oriented. We also are very focused on looking for unique companies with strong competitive advantages. If you're going to own stocks for many years, as we do, you'd better worry about how those companies are differentiated.

And as a growth investor, you don't worry too much about valuation?

Not exactly. I don't really like the whole growth/value distinction. We get labeled as growth investors, but all good investing is trying to find companies whose prices don't reflect their potential. It just happens that we tend to look at the part of the market that has higher growth rates, and those companies often appear expensive based on conventional metrics like P/E. It's true that, on average, high-multiple stocks don't do as well as low-multiple stocks. But we're not buying all those companies -- just ones we think actually deserve those multiples and then some.

Like Amazon.com? It's your second-biggest holding, and it trades at more than 150 times 2014 earnings estimates.

That's a good example. [CEO Jeff] Bezos runs Amazon almost like a private company -- and that's a good thing from our perspective. He's willing to reinvest when he thinks he has an opportunity to generate high returns on capital even if in the short term it hurts the income statement. I remember reading somewhere that Amazon isn't "shareholder-friendly," but having owned the stock from $35 to $400, I consider it very shareholder-friendly.

You first bought into Facebook when it was private and stuck with it through a lot of volatility post- IPO, and it's paid off bigtime. How did you know to hold on?

I think some classic market psychology came into play with Facebook. After the IPO, you had a stock that no longer had a lot of price momentum, and many investors knew that a massive supply of shares would come on the market in late 2012 when lockups expired. That's a liquidity event, and liquidity events come and go; it had nothing to do with fundamentals. But when people know a stock is unlikely to go up, they're more likely to back into a negative view on the fundamentals. All along, we thought the network effect of having all those people on one platform can't be overestimated and that people would start using it more on mobile devices.

One analyst on your team focuses exclusively on big-picture themes. How do you turn that analysis into buy ideas for the fund?

We call him our disruptive-change researcher. His work most often steers us away from areas where big players are likely to be hit by some massive disruption. It's not always clear who the winner of that kind of change is going to be, but there are sometimes clear losers. For example, trends like robotics, 3-D printing, and low-cost energy and natural gas made us see how the world might start shifting away from outsourcing so much manufacturing to Asia, and that led us to pull back from Expeditors International and Li & Fung, which are masters of outsourcing logistics.

Any stocks that you expect to benefit from these disruptions?

One of our top 10 holdings now is Salesforce.com, which partly grew out of our focus on "software as a service" as a disruptive business model. It's also an example of another distinctive part of what we do. Our team manages small- and midcap portfolios as well as large, so we often become aware of companies early in their life cycle. We owned Salesforce. com when it went public, in fact.

You also own some spinoffs, right? Why are you drawn to them?

Yes, Motorola Solutions, for example, which is the data and telecom infrastructure company left over after Google bought Motorola's handset business. Another is Edenred, which is a spinoff of Accor that provides employee benefits and voucher services. These are strong and unique companies, but we like them partly because the market doesn't understand them and the potential for mispricing is high.

When I started out in this business, people tried to out-hustle each other, to do more research and get better information. But now everyone has so much information that there's no advantage to having more. The challenge is to know what information is important and to look at the world differently from everyone else.

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