

# BARRON'S Online

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## Lost Gains, Departed Glory

Lincoln Capital, a storied growth-stock manager, sees assets shrink by 95%

By JONATHAN R. LAING

**FEW BUSINESSES, AFTER ACHIEVING** a certain critical mass, offer the attractive characteristics of equity portfolio management. For one thing, stock funds throw off torrents of cash in the form of management fees while requiring little capital investment. Once rent, salaries and taxes are covered, the remainder of the revenue sluices to the principals of a management concern. The business is extraordinarily "scalable" -- it's not much harder to run \$10 billion than \$1 billion in stock funds. And, under normal circumstances, investors stick with their managers through thick and thin.

So it was a shock when Lincoln Capital Management, one of the most storied large-capitalization, growth stock managers of the past two decades, all but liquidated itself earlier this year.

At its peak in late 1999, the Chicago-based firm ran more than \$40 billion in stock funds, including the then-\$18 billion Vanguard U.S. Growth Fund and sizable pension money for clients from **Motorola** to the New York State Teachers' Fund. With more than \$100 million in annual revenues, Lincoln's employee-owners could've conceivably sold the firm for more than \$500 million.

Moreover, the company exuded propriety and flinty rectitude, from the craggy visage of Abraham Lincoln that it appropriated for its logo to the Waspy persona of its senior active partner, J. Parker Hall III. Hall goes by the first name of Parker ("I won't say what the 'J' stands for since I never used the name to distinguish myself from my father," he says). He had been a successful growth-stock investor for over four decades, first at Chicago's Harris Bank and then, since 1971, at Lincoln. Along the way he built an enviable reputation far beyond Lincoln's home turf.

But none of that kept Lincoln from running afoul of the tech bubble of the late 'Nineties. And, like many mishaps from that era, the full extent of the damage has come to light only recently. Lincoln's equity assets under management have dwindled by some 95%, to just \$2 billion, a result of savage stock-market losses and wholesale customer defections. The company that used to refuse to take on institutional accounts of less than \$100 million has now lowered its minimum to \$25 million. If the truth be known, Lincoln would probably take a lot less. It has likewise changed its name to Lincoln Equity Management, perhaps to distance itself from the recent upheaval.

The drop in Lincoln revenues during its three-year meltdown proved so catastrophic that the younger generation of Lincoln principals was forced in 2001 to abort a buyout plan under which Parker Hall and the other older generation of Lincoln owners were to receive more than \$100 million in future revenues for their interests. At the time, Lincoln borrowed a reported \$25 million from Chicago's Bank One to pay off founder John W. Croghan and other shareholders who had left Lincoln's staff. Only the sale of Lincoln's fixed-income management unit to Lehman Brothers this January allowed the company to retire that bank debt; the move was a relief to both Bank One and Lincoln itself, company officials say.

The company's fall, termed by one pension-fund consultant "an extraordinary and tragic collapse," is a tale of generational conflict, speculative excess and, most of all, a series of miscalculations that combined to create a most malignant storm. On this occasion, it was the butterfly wings flapping in Chicago, rather than in Beijing, that triggered the typhoon.

The older generation at Lincoln rode to glory in the 'Eighties and 'Nineties by buying large-cap growth stocks with strong business franchises and visible earnings streams. They enjoyed the boom years of companies such as **Wal-Mart, Merck, Gillette, Coca-Cola, Pepsi, Procter & Gamble, Toys "R" Us, Reuters Group** and **Waste Management**. They also played some in technology, particularly as the 'Nineties wore on, but in quality names such as **Microsoft, Intel, Dell, Cisco** and biotech giant **Amgen**.

### An Illustrious Past

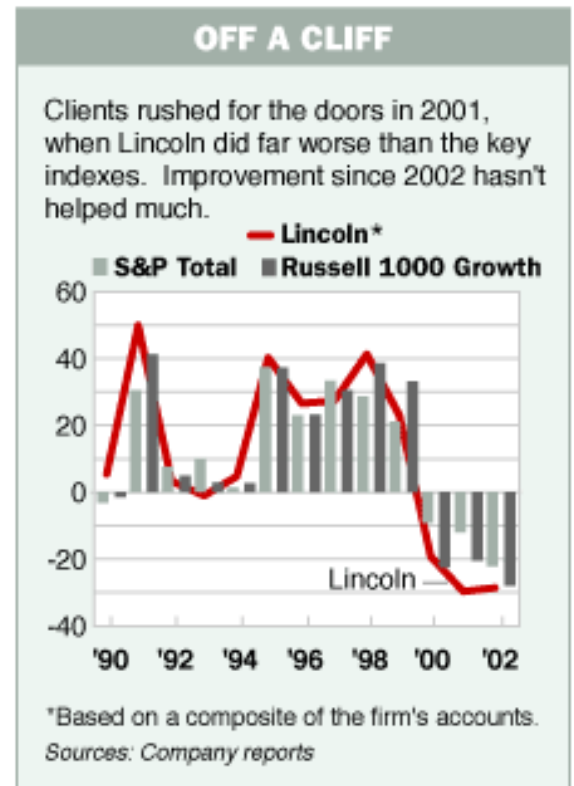
Like any manager, Lincoln had its ups and downs over the years. Value stocks would at times take the play away from the growth arena. "The 'Seventies were obviously tough for us, because after the 1973-1974 bear market, there was scant interest in a growth shop like ours," Parker Hall recalls. "But we persevered in our growth philosophy and bounced back nicely in 1975 and began to grow in the late 'Seventies. And over the next 20 years, we did quite well, despite some ebbs and flows."

Indeed Lincoln did. By the end of 1999, on the cusp of the cruel bear market, its equity assets had grown some 40-fold from the \$1 billion level they stood at in 1984. The performance record was strong. A Donaldson, Lufkin & Jenrette report in January 2000 pointed out that Lincoln had bested the S&P 500 Index by an average of nearly two full percentage points annually over the previous 25 years.

Pension funds so clamored to put equity money with Lincoln that the firm periodically put a freeze on acceptance of new accounts and refused to add more than three or four a year. This selectivity only added to Lincoln's cachet with the all-important gatekeepers, the pension-fund consultants. Membership in Lincoln seemed to have its privileges.

At its peak, Lincoln had just 50 or so equity accounts. One was the Vanguard Growth Fund, which had grown from \$180 million in 1987 (when Lincoln won management of it) to more than \$18 billion. The portfolios' concentration made servicing the accounts easier (it was mostly done by portfolio managers Parker Hall and David Fowler, former president of Lincoln Capital and current head of the surviving company, Lincoln Equity). But it also created the potential for a wildebeest stampede of clients out of Lincoln should anything go wrong.

The Vanguard fund constituted a particular risk. It represented nearly half of Lincoln's equity assets under management. And Vanguard, unlike most mutual-fund families, contracts with a number of independent money managers. Likewise, the company has always had an itchy trigger finger, given its bias in favor of index funds



and skepticism about the performance of active portfolio managers.

Though 1999 represented the high-water mark for Lincoln's equity assets under management, the seeds of the manager's coming debacle were sown in that same year. While Lincoln stock funds rose a respectable 22.8% for the year, besting the S&P's 21.04% gain, they fell well short of the Russell 1000 Growth Index's gain of 33.1%. The Russell had become the bogey that pension-fund consultants used to measure growth managers by. Worse, many of the institutional growth managers that Lincoln competed against had notched increases in 1999 of better than 40%.

At the same time, a changing of the guard was taking place at Lincoln. Parker Hall, then 67, had stepped down as chief investment officer and was no longer involved with investment-committee decisions. The younger generation of portfolio managers and analysts worried that Lincoln was being left behind other growth houses with its portfolio of more traditional tech names such as Microsoft and Intel. The Russell Index was being gunned higher in 1999 by newer arrivals such as AOL, which doubled in price during its first year in the index.

So the fateful decision was made in early 2000 to get on the new tech bandwagon and load up on smaller, racier momentum plays in the Russell. Much of the Microsoft and Intel was sold in favor of New Wave names including **Redback**, **Extreme Networks**, **Juniper**, **Broadcom**, **EMC**, **Ariba**, **Akamai** and **Amazon**. "We got caught up, like a lot of other folks, in the themes of networking, storage and enabling software," David Fowler remembers ruefully. But that was only part of the story. Lincoln was trying to play catch-up after badly underperforming so many of its peers in 1999.

The folly was only compounded as 2000 wore on. A midyear revamping of the Russell 1000 pushed its tech weighting to over 50% of the index. That weighting had been around 35% in late 1999. The young managers at Lincoln decided to merely add to their momentum stocks, rather go to more defensive tech names, in order to keep their discipline of staying within three percentage points of sector weightings in the index.

Lincoln's comeuppance came quickly and brutally. By the fourth quarter of 2000, its new technology holdings were getting smashed, along with Lincoln's older holdings such as Cisco and **Sun Microsystems**. In November of 2000 alone, its portfolio lost a horrendous 18%. For the entire year of 2000, Lincoln's equity portfolios lost 19.8%. While better than the Russell's drop of 22.4%, that was more than 10 percentage points worse than the S&P's loss of 9.1%.

The carnage continued in 2001, when Lincoln's longtime philosophy of buy-and-hold cost the firm dearly in the tech-stock debacle. That year, its portfolios dropped 30.5%, compared with declines of 20.4% and 11.88% for the Russell and S&P, respectively. Lincoln had committed the ultimate money-manager sin: After failing to play good offense in 1999 by dramatically trailing rivals in an up stock market, it had played poor defense in 2000 and 2001 by incurring larger losses than the indexes in the technology meltdown.

The first major client to bolt was Vanguard. In June of 2001 it took away its entire fund, with assets then of \$12 billion. The move was hardly a surprise. Morningstar's Christopher Traulsen noted acidly just weeks before the firing that if the Vanguard U.S. Growth Fund weren't careful, "It might set a new standard for futility in the large-growth category."

Lincoln mightn't have been dealt with so harshly had Jack Bogle still been head of Vanguard. He was a longtime friend of Parker Hall. Likewise, he believed in taking away only half the money from a lagging manager to give to someone new. That way, one achieved through diversification a result closer to an index fund and reduced the likelihood of further financial accidents. But he'd been gone from Vanguard for several years.

So all of the money was pulled and given to Alliance Capital, a growth-fund shop. Ironically, Alliance has done even worse since. Over the past 15 months, Ariel Premier Growth Investment -- the only remaining Lincoln client that discloses results -- is down 22.4%, while Vanguard Growth, under Alliance, has dropped more than 27.8%.

Lincoln's results since the start of 2002 have closely tracked the Russell 1000 and the average large-cap growth fund. But this stabilization hasn't mattered much. After Vanguard departed, a number of pension-fund clients followed. Vanguard proved to be the "bell-cow." In all, some 35 of Lincoln's onetime roster of 50 clients went out the door.

Parker Hall, for one, is philosophical about the collapse of the firm he'd done so much to build and the obvious pecuniary loss of the aborted buyout by the younger principals. These days he spends much of his time serving as a trustee of the University of Chicago and an investment committee member at alma mater Swarthmore College. He's also involved with the Chicago Symphony and various civic organizations.

"With hindsight, we can see that some of the stocks that got into our portfolios in 2000 were kind of sparky companies that had big market caps but insubstantial businesses -- but I won't criticize those decisions," he says. "The younger crowd at the firm was persuaded by the future of these companies, and I'd had a hand in hiring all of them. Therefore, I'm as much responsible as they were for any bad decisions that might have been made. We were all trying to do our best."

Dave Fowler, who heads up the small successor firm to Lincoln, concedes that Lincoln made a terrible mistake by going for broke in 2000 and 2001, rather than playing better defense. At least Lincoln is now debt free and will have a new lease on life. "We don't have to be nearly as successful as we were before to make this a fabulous firm to work at," he adds brightly.

A bull market in growth stocks would certainly help.

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