MORNINGSTAR®

Reprinted by permission of Morningstar, Feb. 08, 2013

LKCM Equity Instl LKEQX

A steady performer.

2-8-13 | by Katie Rushkewicz Reichart, CFA

LKCM Equity continues to strike the right balance.

In a year when Apple AAPL and financials stocks significantly boosted the S&P 500, this fund still nearly matched the benchmark's 16% gain in 2012 despite owning a smaller slice of both. A good chunk of the fund's best performers came from names with lower market caps, several of which aren't in the benchmark, including Jarden Corporation JAH and Valmont Industries VMI.

While the fund is at heart a large-cap core holding, longtime manager Luther King prefers to look across the market-cap spectrum, relying on insights from the firm's 35-member investment team to uncover opportunities other large-cap funds might ignore. As a result, the fund's active share (a measure of how distinct a portfolio is from the benchmark) has averaged 72% during the past five years while the typical large-blend and large-growth fund has clocked in around 66%.

No matter the market cap, King focuses on firms with high returns on invested capital and low leverage, qualities that have helped the fund maintain a moderate profile. He's also been careful to balance different parts of the portfolio. For instance, the fund owns more industrials than the benchmark, but it also has a lighter technology stake, meaning the fund doesn't have an outsized bet on capital-intensive companies.

Over time, the fund's emphasis on financially sound firms, coupled with good stock-picking, has led to favorable results. The fund has proven remarkably resilient, losing just 83% as much as the S&P 500 in down markets. That pattern has helped damp its volatility relative to the benchmark and peers, but it hasn't curbed returns: The fund has beaten 70% of all large-cap funds since its late-1995 inception.

The fund's small asset base is a plus, allowing it to remain flexible. Fees are reasonable despite its size. Overall, it's an appealing option for investors.

Process Pillar: Positive

A credit analyst by training, manager Luther King has always focused on such fundamental metrics as return on equity, return on assets, return on cash flow, and financial leverage, looking for solidity and sustainability. King typically prefers companies with high returns on invested capital, saying that provides management with the flexibility to build out the business value of the enterprise. The firm's 35-member investment team does on-the-ground research and meets with management teams to get a better sense of a company's prospects before buying.

King employs what he considers a core strategy, avoiding deep-value turnaround plays while remaining sensitive to valuations. The fund typically has a higher historical growth rate and price/earnings ratio than the S&P 500 Index but lower debt levels. It also has below-average turnover ranging from 20%-30%, indicating King prefers to be patient with his picks rather than trade often.

The fund typically owns 70-80 names, keeping positions under 3% of assets. As a risk-control method, an exceptions report flags stocks in the portfolio that dip below their 200-day moving average, show an unusually high amount of insider selling, or have other alarming trends. The report triggers an automatic review by the analyst and others on the research team. The goal is to eliminate the most dangerous tail of the portfolio.

The fund is most appropriately used as a large-cap core holding. However, it won't always fit neatly into the Morningstar Style Box. That's because King looks for good businesses, whether they're classified as value or growth stocks. In recent years, the portfolio has skewed toward the growth side of the style box, with picks such as Apple AAPL and Google GOOG making an appearance (though to a smaller degree than its peers). The fund moved from the large-blend to the large-growth category in 2012, but the shift doesn't suggest a change in process.

King is also willing to venture across the market-cap spectrum. The fund's $25 billion average market cap as of December 2012 was less than half the S&P 500's, and it typically owns fewer mega-cap names than peers. The portfolio melds together big blue chips, including IBM IBM and Exxon Mobil XOM, with smaller-cap names that aren't commonly found in large-cap funds, such as Raven Industries RAVN. As a result, the fund's active share (a measure of how distinct a portfolio is from its benchmark) has averaged 72% the past five years, whereas its typical large-growth and large-blend peer have averaged 66%.

Morningstar's Take LKEQX

Morningstar Rating	★★★★★
Morningstar Analyst Rating	Silver
Morningstar Pillars	
Process	Positive
Performance	Positive
People	Positive
Parent	Positive
Price	Positive

Role in Portfolio

Core

Fund Performance LKEQX

Year	Total Return (%)	+/–Category
2012	15.69	0.35
2011	3.30	4.57
2010	17.77	3.76
2009	27.01	-1.16

Data through 12-31-12

Reprinted by permission of Morningstar, Feb. 08, 2013

While the fund's sector weightings result from stock-picking, they haven't wildly deviated from the S&P 500's. In recent years, the fund has owned fewer financials and technology stocks than the benchmark while holding greater stakes in industrials and materials.

Performance Pillar: Positive | Katie Rushkewicz Reichart, CFA 02/06/2013
This fund has a solid long-term track record. Since its late 1995 inception through January 2013, the fund has gained 7.7% annualized—just slightly edging the S&P 500 Index, but ahead of 70% of all large-cap funds. More impressive, the fund has been less volatile than peers and the benchmark, as measured by standard deviation, leading to a strong risk/reward profile.

The fund has adeptly navigated tough markets. It held up better than the typical large-blend and large-growth fund during both the early 2000s' bear market and the late 2007-early 2009 financial crisis. More recently, the fund was up 3.3% in 2011, a year when the average large-blend fund lost 1.3% and the average large-growth fund declined 2.5%. This pattern fits with the benchmark, too, with the fund losing just 83% as much as the S&P 500 Index in down markets.

The fund won't always exceed the benchmark or peers in robust markets, and relative returns are bound to lag in years like 2009. However, it has held its own in various market environments, steadily accumulating a consistent record. The fund has beaten the S&P 500 in two thirds of the rolling three-year periods since inception, a number that grows to 70% relative to the large-blend category and 75% for large growth. The fund's consistency and moderate profile make it easy for investors to own.

People Pillar: Positive
Lead manager Luther King founded his eponymous firm in 1979 and has steadily built up a research staff. The firm now has 35 investment professionals, the majority holding CFA or CPA designations. It's a robust outfit for a firm of its size (it had $11.3 billion in assets under management as of December 2012). Members average 20 years of investment experience and roughly 12 years at LKCM. While King takes the lead, three comanagers are named on the fund for backup. They include Scot Hollmann, who joined LKCM in 1983, Steve Purvis, at the firm since 1996, and Mason King, a team member since 2004. Analysts cover different sectors and are compensated on one-year performance, the quality of their research, their impact on the portfolios, and other criteria. Unlike some fund shops, where the analyst role is used as a stepping-stone to a portfolio manager job, the analyst track at LKCM is a career path, and analysts' pay can be above that of managers if they're doing good work. To ensure that the analysts feel they're having a direct impact on the portfolio, 20 top analyst picks are included in the portfolio regardless of the manager's view on them. Each consumes at least 0.8% of the fund's assets, though it could be higher if the manager has more conviction in the pick. The analysts' compensation is directly tied to these picks. King has invested more than $1 million in this fund, indicating his financial interests are aligned with shareholders'.

Parent Pillar: Positive | Katie Rushkewicz Reichart, CFA 01/29/2013
J. Luther King, Jr. founded Fort Worth, Texas-based Luther King Capital Management in 1979. The 100% employee-owned firm got its start managing money for high-net-worth individuals, foundations, and institutional investors. The firm doesn't have a distribution arm and lacks a presence with advisors, so the firm's eight mutual funds made up just 14% of the firm's $11.3 billion in assets under management as of December 2012. However, the small size of the funds hasn't necessarily led the fund board (composed of King and three independent trustees) to set exorbitant expense ratios. For example, the $176 million LKCM Equity's 0.80% expense ratio is well below the 0.99% median for no-load large-cap funds. Fees for the Catholic-based Aquinas funds (which the firm purchased in 2001) are higher, though, and the firm's average fee level percentile rank clocks in at 57 (slightly above median). The fund board has looked out for investors' interests in other ways, lowering the minimum investment amount to $2,000 from $10,000. What's more, the firm has done a good job of retaining investment professionals: Manager tenure averaged 11.2 years as of December 2012. Two thirds of the firm's assets land in funds where at least one manager has more than $1 million invested in the strategy, showing financial alignment with fund shareholders. Overall, the firm's research-intensive process has led to strong long-term risk-adjusted performance.

Price Pillar: Positive
This fund has one share class, which is categorized as institutional in Morningstar's database given the fund's name. Relative to the institutional large-cap peer group, the fund's 0.80% expense ratio is average. However, the minimum investment for the fund is only $2,000, which makes the no-load peer group more relevant for price comparisons. In this respect, the fund's 0.80% expense ratio is quite reasonable compared with the no-load, large-cap peer group, which has a median fee of 0.99%. It's impressive that the fund company has kept costs down despite the fund's tiny asset base of less than $200 million.