

BARRON'S

THE DOW JONES BUSINESS AND FINANCIAL WEEKLY

www.barrons.com

APRIL 6, 2009

Interview with John E. Deysher Portfolio Manager, Pinnacle Value Fund

Time for the Tough to Go Shopping

By J.R. Brandstrader

IN A REVERSAL, BEATEN-DOWN SMALL-cap stocks have outperformed the Standard & Poor's 500 since the market began to rally three weeks ago. Looking for some perspective on small-caps—and other things—*Barron's* sat down recently with John E. Deysher, 54, who has run the \$53 million Pinnacle Value Fund (ticker: PVFIX) since its inception on April 1, 2003. The fund has benefited greatly from small-caps. Despite its anniversary date, the fund's returns have been serious business, besting 99% of its peers year-to-date and over one, three and five years. A Royce Funds alumnus, Deysher agrees with his mentor, Chuck Royce, that investors shouldn't let the recent horrors on Wall Street scare them away from equities. If they do, they'll miss the big bounce typically seen in small-caps when the economy is recovering. When times are tough, says Deysher, the tough go shopping.

Barron's: Why have small-caps outperformed?

Deysher: Going into recession, small-caps lag because customers and vendors concentrate their business on larger firms that are more likely to survive. Going into recovery, however, small-caps generally do better than big-caps because customers and vendors feel they might get a better deal with more companies in the mix. Depending on the strength of their conviction that the recovery is real, stock prices can pop almost immediately. Any whiff of good news could trigger a rally.

What do you see ahead for the economy?

We are starting to see isolated pockets of good news: New-home sales were up, and some durable-goods orders are up. But until consumers, who drive two-thirds of the econ-

omy, feel confident that their jobs are going to be there, that they are still going to be living in their homes, they are going to be in the bunker. And nobody knows how long that is going to last. The key is consumer confidence. If consumers become confident, businesses will become confident.

Do you think the stimulus package is helping or hurting the market?

The monetary stimulus is definitely helping. We are avoiding a total breakdown of the system. The commercial-paper backstop did its job. That market is functioning. As for the fiscal stimulus, it's too early to tell. It's a big number—\$800 billion—and if it is used effectively on education, infrastructure, alternative energy, that's good. But if it just becomes a full-employment act for government bureaucrats, that's not good. None of this changes the way we look at stocks.

Why not?

Current stock prices reflect pretty dire economic circumstances. But, in general, businesses have been very responsible. They are bringing down inventories. They are paying off debt. U.S. corporations are going to be well-prepared for the ultimate uptick in consumer demand, whether it is six months from now or 18 months from now. A lot of those profits are going to flow right to the bottom line, and common stocks are going to do pretty well.

Barron's: How well?

Coming out of a recession, the returns you can earn by being invested in stocks are phenomenal. Statistics show that the Russell 2000 has rebounded 15% to 20% annually in the two, three, four years after the market starts to recover.

So why do you have a big side bet on cash?

Pinnacle Value Fund (PVFIX)
877-369-3705 ext. 115

It has gone down a lot recently.

Oh, really?

Earlier in the year when prices were very low, we put the cash to work. We ended the year at 50% cash, and now we are 35% cash.

Where did you put it?

We added some new positions and we bought more of just about all of our major holdings. If you do the homework and due diligence and you like it at one price, you should like it even more when the market is giving it away. You must have the courage of your convictions to be a successful investor.

So why small-caps?

We're not just small-cap investors. Our fund is called a value fund. Usually, the most attractive merchandise has been in the small- and even micro-cap arena. But recently, we have put some mid-cap names in the portfolio just because they met our criteria. The weighted average market cap at the end of 2008 was probably \$280 million. I would guess that it is a little higher now. Yes, our strength is always in small-cap, but we can buy mid-cap as well.

Forget size. What do you look for in a stock?

Good corporate governance, good management, a history of profitability and a solid balance sheet. We also look at dual-class share structures and who is on the board of directors. If a business is subject to technological obsolescence within five to 10 years, we probably

(over please)

won't invest in it. Most of all, we have to understand it.

What would make you avoid a stock?

If a company has a leveraged balance sheet, we won't look at it, and we have some very strict criteria in terms of how you define leverage.

Financials have led past recoveries. Do you think it is time to dip in?

Yes, I do. The financial index was down 85% at its low. The financial system as we know it will always be around. So, when an index is marked down that much, you have to stop, take notice and say: "What are the companies we want to own here?"

How about an example?

Preferred Bank [PFBC], a small Southern California-based community bank with \$1.5 billion in assets. It serves the Chinese-American community in Los Angeles. They've always had a strong balance sheet. I think they've run the business responsibly. The insiders own 30% of the stock, and they've been big buyers recently. But like a lot of other community banks, they got overextended in condo-construction loans, and they are working through those now. And their nonperforming assets are going up. But the balance sheet is strong enough to absorb that. And, ultimately, as the write-offs decline, that will uncover the underlying earnings power of the bank, which is 70 or 80 cents a share. The book value is 16. It is now at 5 and yields 6%. This is an example of a bank that has been beaten down, but whose long-term prospects are good. Like a lot of other community banks, they have to get through the next couple of quarters without nonperforming assets going up too much and further eroding their book value.

What else?

Wesco Financial [WSC] is a Pasadena-based holding company. They have interests in reinsurance, bank insurance and furniture rentals, and they own a steel service center, which cuts metals to order for customers. We like Wesco because at one point it was \$500 a share. It got down to \$200, and we figured this is a giveaway price for the underlying value of the businesses. Yes, they have some economic sensitivity for sure. But the biggest part of the business is reinsurance, which has been hurt by lower interest rates, declining portfolio values and a lot of claims from Hurricanes Ivan and Gustav. They will have difficulty raising capital because many of the stocks are trading below book value. One way to replenish capital is to raise rates. So, I think reinsurance rates are going up. It's no accident that War-

ren Buffett recently took a big position in Swiss Re, one of Wesco's competitors. He also owns, via Berkshire Hathaway, 80% of Wesco at a discount to book, which rarely happens because Wesco is run by Charlie Munger, Buffett's long-time associate.

So you are a big fan?

I like Warren, yes.

But he sort of took a haircut.

We have all taken haircuts. We've all had our mistakes. But he is the master.

What else?

First Acceptance [FAC] is a Nashville-based nonstandard auto insurer. That means they provide insurance to people who don't qualify for standard auto insurance, people who have credit problems or things of that nature. And when they hear the word nonstandard, a lot of people run in the other direction. But the company provides a useful service, because people need auto insurance. The soft economy has hurt their customer base, because if you get laid off from your job, chances are you will drive less and may let your insurance lapse. That's hurt the stock recently. However, the remaining customers that still have jobs tend to be better risks. So while the premiums have come down a bit, so have the claim costs. They are reducing their expenses and they have put rate increases through in many of their states. The insiders own a big chunk of stock and they've been buying it. It is still trading at a big discount to book and ultimately the stock, which is around 3 right now, could make 40 or 50 cents a share.

I see you also have the private-equity group MVC Capital. Isn't private equity having trouble accessing capital?

There is probably no other industry that is less loved. All those stocks are down for a couple of reasons. No. 1, a lot of them have fairly leveraged balance sheets and questionable investments. MVC Capital [MVC], however, has a pristine balance sheet, and most of its investments are holding up fairly well. Second, there is some question as to what the values of these private companies are. Clearly, valuation multiples are coming down, but MVC is very conservative in its valuations. It has a net asset value of \$17 a share right now and is trading for 9. They have taken markdowns on a couple of portfolio companies. But we think most of the 40 or so companies they have in the portfolio are still doing OK. Their ability to access capital is not much of an issue since MVC is not dependent on a lot of debt.

Where is it getting its money?

They have a big equity cushion, and their

loans are maturing so they are getting back principal, which has to be reinvested. Eventually, they will sell some of their equity investments, hopefully at a nice profit. So right now they are not doing a lot of buying, because they are being conservative and hoarding the cash that they do have. But they are going to be well positioned going forward, because the current low multiples will make merchandise available at good prices.

Any big worries?

Yes. If the stimulus package doesn't work and we continue on this vigorous cycle of negative news that further drives down confidence . . . that's not good.

Barron's: OK, we will turn off CNBC.

Anything else?

The bond market. We've had 30 years of a bond bull market. The long-term bond was at 16% back in the 1980s. It was down at 2½% in December 2008. What happens if interest rates go up? I'm not sure that prospect is on a lot of people's radar screens.

Higher interest rates would be great for all the born-again savers, wouldn't they?

That goes without saying, but if the economy gets rolling, there is going to be a lot of competition between the government and Corporate America for capital. I'm not sure there will be enough foreign buyers for U.S. securities to absorb all of that debt—they've got their own problems. That means bond prices could tumble, and price/earning multiples could contract as interest rates rise.

You are a big advocate of dollar-cost averaging. Do you think investors have the stomach for that after all of the carnage on Wall Street?

The anxiety is understandable. They've seen huge quantities of their net worth go away in terms of their home values and their security portfolios. They're worried about their jobs and being able to keep their homes. Many of the trusted names on Wall Street and elsewhere no longer exist. The economy could get worse before it gets better, but eventually it will get better.

What do you tell the nervous investor?

Stay conservative and look for signs that maybe the economy is firming and, at some point, tip-toe back into equities. The Russell 2000, over a 30-year period, has earned about 11% per year. That's pretty good, and it includes years like 2008 when it was down 34%. The good years more than offset the bad years.

Thanks, John. ■