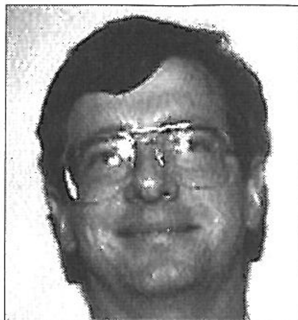
MONEY MANAGER INTERVIEW

A Bottom-Up, Value Approach to Investing in Small Caps

JOHN E. DEYSHER, BERTOLET CAPITAL LLC



JOHN E. DEYSHER, CFA, is President of Bertolet Capital LLC, adviser to the Pinnacle Value Fund, a diversified, SEC-registered mutual fund. He is responsible for the Fund's daily investment activities and has more than 25 years of experience in the investment management business. From 1990 to 2002, Mr. Deysher was a Portfolio Manager and Senior Analyst with Royce & Associates, LLC, an investment firm specializing in the securities of small-cap companies. Mr. Deysher began his investment career in 1983 with Kidder Peabody & Co., where he managed equity and fixed income portfolios for individuals and small institutions. He holds a bachelor's degree from the Pennsylvania State University, and master's degrees from Indiana University Bloomington and the University of California, Berkeley.

SECTOR — GENERAL INVESTING

(ACU505) TWST: Generally speaking, why do you like small-cap stocks considering the market and the macroeconomic environment in which we're currently operating?

Mr. Deysher: We like small-cap stocks or a couple of reasons. First, since many have a single line of business they are easier to understand than larger companies with multiple lines of businesses. Second, they generally have more conservative financials because they are more subject to economic headwinds than larger companies with diversified product lines. Third, small companies are often run by owner/operators who have a large percentage of their net worth in the business. Finally, small-firm managements tend to be much more accessible, which is an important part of gathering information critical to our investment process.

In terms of the current environment, if we are approaching the bottom of the economic cycle, small companies tend to do better coming off of the bottom. I think we may have a ways to go before we reach that bottom, but in the meantime we're building positions in small companies we think will do quite well when the turn comes.

Highlights

John E. Deysher discusses his strategy for investing in small-cap stocks. He says small-cap stocks offer advantages, as they are easier to understand, they have more conservative financials, their management is invested in the companies and they are more accessible. He focuses the Pinnacle Value Fund in deep-value equity, and invests in four themes: undervalued assets, turnaround stories, growth at a reasonable price, and special situations like spinoffs and restructurings. He utilizes a bottom-up approach to select names and carries equity for a holding period of two to three years. Mr. Deysher discusses his sell discipline and a few names that represent his investment strategy and philosophy.

Companies include: EMC Insurance Group (EMCI); MVC Capital (MVC); CSS Industries (CSS); Hooker Furniture Corp. (HOFT) and Handy & Harman Ltd. (HNH).

TWST: Would you give us an overview of the types of equities you include in the Pinnacle Value Fund?

Mr. Deysher: Sure. Our mandate is to invest in securities of small- and micro-cap companies that we feel are undervalued relative to their potential earnings power or asset values. Many of them are overlooked in the marketplace and trade below the radar screen of the institutions, so we have less competition. Our approach is deep-discount value, so stocks must be absolutely cheap, not just relatively cheap. We seek out the most compelling opportunities with the best risk/reward characteristics and a decent margin of safety.

Generally, our ideas fall into one of four themes. The first is undervalued assets where the stock trades at a discount to liquidation or private sale value. Next are turnarounds where a firm is recovering from depressed results due to company specific or industry issues. We also like growth at a reasonable price where a fast-growing company is available at a reasonable valuation. Finally there are special situations which may include spinoffs and bankruptcy reorganizations.

Where possible, we look for catalysts that might propel the shares upward. These might include a new CEO with a mandate from the board to get the firm back on track. New products, distribution channels or cost reductions can also be effective catalysts. Major insider buying or share repurchases are also worth noting. Finally, and this happens a lot, the catalyst may be a cyclical rebound in earnings. The result is earnings growth, an expanding p/e multiple, and hopefully, a higher share price. Those are some of the catalysts we look for.

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TWST: When you spoke with us in November 2009, you said there were slim pickings for the kinds of stocks you're looking for. Is that still the case?

Mr. Deysher: Let's step back a second and look at how the Russell 2000 benchmark did between the bottom in March of 2009 and its recent high in April of 2011. During that period, the Russell 2000 recaptured all of the ground that it lost and more than doubled in the last two years. Since then, the Russell 2000 has declined somewhat. So yes, small caps are cheaper, but not overwhelmingly so in our opinion. There are some good values out there which we are buying, but we don't see the wholesale bargains we did in March 2009. The markets remain extremely volatile, so we'll be patient and try to exploit that volatility whenever possible.

TWST: Would you walk us through your process of selecting stocks for the Fund?

Mr. Deysher: Absolutely. Our approach to the research process is fairly straightforward. We start with an idea which can come from several sources. Once we have an idea, we'll do what we call grassroots research on the company. We'll try to understand the firm and the industry within which it operates. We'll look at the competitive landscape, the bargaining power of key customers and vendors, the threat of substitute products including imports, barriers to entry and the role of technology. We'll do database searches on the key executives and board members. If Wall Street publishes research on our target, we'll take a look at that as well. We try to develop an intellectual framework from which we can make further evaluations.

We then try to think through the strategic, operational and financial priorities that a company needs to address going forward. Ultimately we try to formulate several critical issues that we think will make or break a company. At that point, we try to interview top management, either the CEO or CFO, to see how they address the critical issues we've highlighted. Sometimes they will confirm what we're thinking, sometimes not. It's a dialogue where we're hoping to gather the important intelligence we need to make a decision on whether to move forward. Oftentimes we'll discover things we haven't thought about which leads to further analysis. The process is constant information gathering. Ultimately, we reach the point where we either accept it as part of our universe or discard it. If accepted, we do our valuation work, and assuming the share price is below intrinsic value, we'll generally begin accumulating shares.

TWST: Where do your ideas come from?

Mr. Deysher: From a variety of places. We scan the new low list daily, which often turns up ideas worth investigating further. We'll run proprietary screens allowing us to filter companies that meet our strict financial criteria. We'll also track SEC filings which might indicate an ownership change or other data that's of interest to us. We read a lot of annual reports, trade periodicals, general business publications and legal documents which consistently turn up good ideas. Finally, whenever we're interviewing executives, we'll ask them who is their toughest competitor, best customer and best vendor.

TWST: Are there any sectors that have emerged in the past couple of years as being more likely to include the kind of stocks you look for?

Mr. Deysher: All of our work is stock by stock, bottom up. We gravitate towards value, so if we're finding values in a bunch of stocks in the same industry, that sector may become a bigger part of our portfolio. As of June 30, 2010, we have a fairly good weighting in financial services, including property and casualty insurance companies. P&C insurers are down for several reasons, and we think many represent good value. We have a smattering of commercial bank special situations and a few business development companies, which specialize in areas that we don't have access to directly. So financial services is a sector where we are quite active at the present time.

1-Year Daily Chart of EMC Insurance Group

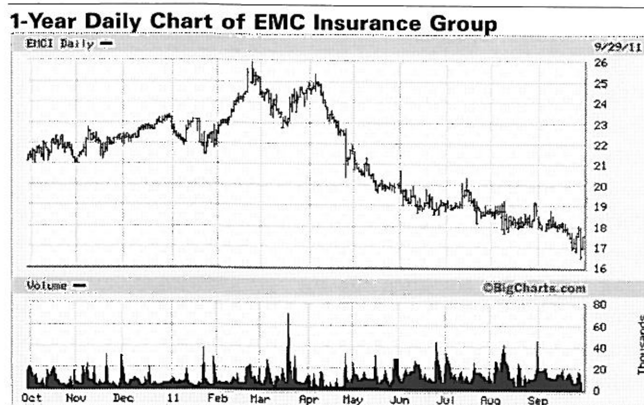

Chart provided by www.BigCharts.com

TWST: Last time you spoke with us, you said you were not afraid to take contrarian positions. Would you tell us about some of the contrarian investing ideas you embrace at this point in time?

Mr. Deysher: Yes, within the financial services sector we just spoke of, the first is **EMC Insurance** (EMCI). They're a Des Moines, Iowa,-based regional P&C insurance company with clients primarily in the Midwest and Southeast. As you know, those areas

were hard hit by spring storms, tornadoes and floods. As a consequence, they've had some claims which led to short-term losses. However, we think the losses will be limited, and the market's reaction has been overdone. **EMC** shares are down from $26 to $18, a 25% discount to tangible book value. They have a good franchise, strong management, a solid balance sheet and the shares yield 4.2%.

"For each position we acquire, we try to buy at very reasonable valuations. We're patient and wait for the shares to decline to a price level where we think our downside is limited. It doesn't always happen that way, but as absolute value investors, we try to remain disciplined in the price we pay."

Another idea is **MVC Capital** (MVC), a business development company that makes equity and/or debt investments in small private companies. They provide capital required to fund external or internal growth, an ownership change or a management buyout. The shares are down from $15 to $11 and sell at a 35% discount to the underlying NAV. The yield is 4%, and we think that when the economy turns, the small companies they invest in will do quite well.

In the nonfinancial services area, we recently invested in **CSS Industries** (CSS). They're a Philadelphia-based manufacturer of seasonal gift wrap, ribbons/bows and greetings cards which they sell to mass merchants and other retailers. They have been around since 1923, and the beauty of their business is they outsource everything. All manufacturing is done mostly in Asia, so they do not carry a lot of fixed manufacturing assets, providing them with more flexibility. The shares are down from $22 to $16, a 12% discount to tangible book value, and yields 3.5%.

Another idea is **Hooker Furniture** (HOFT), founded in 1924 and headquartered in Martinsville, Va. They make and sell wood case goods which are the hard furniture you have in your home or office as opposed to softer upholstered furniture. The industry is down because of lower new and existing home sales, but eventually furniture wears out and needs to be replaced, and **HOFT** is good way to participate in that. Their business model is similar to **CSS** since they outsource all production to the Far East and thus have minimal fixed assets. The shares are down from $15 to $9, a 25% discount to tangible book value, and have a dividend yield of 4.4%. So that gives you a couple of manufacturers in addition to the financial services ideas we talked about earlier.

TWST: On the flip side, are there types of small-cap stocks that you would shy away from, equities that might meet a few of your criteria, but have some sort of red flag that keeps you away?

Mr. Deysher: We really look at anything, except for companies that we exclude for the following reasons: The first are companies with leveraged balance sheets, which we exclude since small-cap firms have enough issues to deal with operationally and we don't want to take the financial risk. Second, if the business is beyond our circle of competence, we'll exclude it. This includes things like high-technology and biotech companies which we don't understand and where the technology is constantly changing. Finally, if there are any types of governance issues or major conflicts or interest we stay away. We want managements that are shareholder oriented and make money with the shareholders, not off the shareholders. So other than those three types of issues, we'll consider anything at the right price.

TWST: What would you say are the primary risks associated with investing the types of small-cap stocks in your Fund, and what is your risk-management strategy?

Mr. Deysher: There are a few risks. Small-cap companies are much more vulnerable to economic headwinds. They have more limited product lines, management scope, distribution, research and advertising dollars than larger firms. We try to overcome this by thoroughly understanding the business model and making sure the balance sheet is strong. Second, we face the risk that the entrepreneurs who run the firm put themselves ahead of the outside shareholders like us. We try to overcome this by doing our homework on management and meeting with them, which we have done for virtually all our holdings. A third risk would be that we miss something. Since very few of our firms are covered by Wall Street, we do most of the due diligence ourselves, so we must get the data and facts correct. We try to overcome this risk via a detailed research checklist. Finally, we face the liquidity risk that once we've built a position we may have a tough time selling it if things don't work as planned. Many of our shares are thinly traded, which we try to overcome by working with brokers who specialize in this type of merchandise.

1-Year Daily Chart of CSS Industries

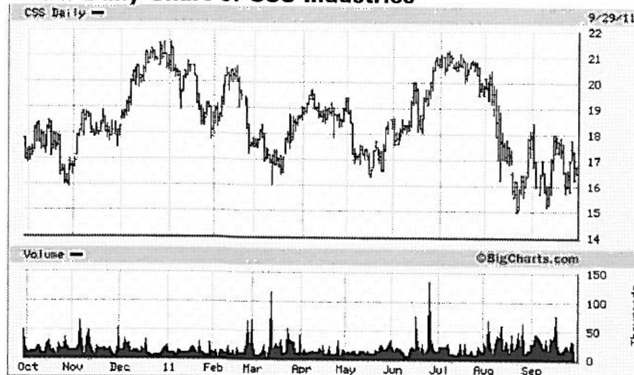

Chart provided by www.BigCharts.com

We also try to minimize risk by being adequately diversified across multiple companies and industries. For each position we acquire, we try to buy at very reasonable valuations. We're patient and wait for the shares to decline to a price level where we think our downside is limited. It doesn't always happen that way, but as absolute value investors, we try to remain disciplined in the price we pay. Finally, we try to limit downside risk by carrying a lot of cash in the absence of good ideas. This helps limit our downside during market declines, but of course mutes our performance in an up market.

TWST: Would you tell us about your sell discipline via

an example of a stock that you sold in the recent past?

Mr. Deysher: Our holding period is two to three years, which is normally the amount of time it takes for our companies to do what we expect of them. We typically sell when one of four things happen. First, we make a mistake in our facts, reasoning or logic. We recognize our error and try to exit with as little damage as possible. We'll also sell when a stock reaches a price that we think more than adequately reflects its business prospects. The higher the price, the higher the risk, and we'll generally trim back a position we think is fully valued. Of course, the right price may be an evolving target, so we'll normally scale out of an idea rather than sell it all quickly. Third, if an expected catalyst doesn't materialize over two or three years and we think the stock is dead money, we'll start to scale out of it. However, if the catalyst materializes but the stock doesn't move, we'll hang in there because eventually the share price will reflect reality. Finally, if the insiders become significant sellers, that's probably our cue to move on as well.

TWST: Is there an example you can give us of a stock that you sold recently?

Mr. Deysher: Yes, we owned shares of **Handy & Harman** (HNH), an industrial conglomerate, for many years and did quite well with it. Earlier this year, the shares rose sharply to $16 and we thought that price was more than business fundamentals justified, given the economic outlook. We sold some shares near that price, and we're fortunate we did as the shares are now significantly lower. **Handy** is a well-run firm, but valuations got a little crazy, so we lightened up.

TWST: How would you describe the investor who would be an ideal match for the Pinnacle Value Fund?

Mr. Deysher: The Fund is best suited for people who want a diversified exposure to a basket of well-managed, conservative small firms selected with an eye towards value and an adequate margin of safety. Our alpha thesis is a high-conviction portfolio with a long-term horizon. Shareholders should be patient and not day traders or momentum investors. We want investors who will be shareholders for a period of years, and over that period we think will be able deliver above-average, risk-adjusted returns. Our portfolio manager is a large shareholder who views our shareholders as true partners in the Fund.

TWST: Thank you. (MES)

JOHN E. DEYSHER, CFA
President
Bertolet Capital LLC
745 Fifth Ave.
Suite 2400
New York, NY 10151
(212) 605-7100
(212) 486-1543 — FAX
www.pinnaclevaluefund.com