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MONEY MANAGER INTERVIEW

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Searching for Small Cap Opportunities with Minimal Downside Risk

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JOHN E. DEYSHER, CFA, is President of Bertolet Capital LLC, adviser to the Pinnacle Value Fund. He is responsible for the fund's daily investment activities and has more than 40 years of investment management experience. From 1990 until 2002, Mr. Deysher was a Portfolio Manager, Senior Analyst with Royce & Associates, an investment firm specializing in the securities of small cap companies and adviser to the Pennsylvania Mutual Fund. Mr. Deysher began his investment career with Kidder Peabody in 1983, 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 both Indiana University, Bloomington (Business) and the University of California, Berkeley (Engineering). He is a CFA charterholder, and lives and works in New York City.

SECTOR — GENERAL INVESTING

(AHV551) TWST: Why does a smaller cap value fund make sense in today's market environment?

Mr. Deysher: We think most investors should have a portion of their equity portfolio in small cap for several reasons. First, smaller companies are often overlooked in the marketplace since institutional investors can't buy enough shares to make it worthwhile, and brokerage firms can't generate enough commissions. As a result, research coverage is often minimal and the shares are inefficiently priced relative to fundamentals. Since we do all our research first-hand, this is an opportunity for us.

Small companies often have substantial insider ownership, so their interests are aligned with ours. Many are run by entrepreneurs, who have a substantial portion of their net worth on the line every day. Many small companies are conservatively financed with strong balance sheets that provide financial flexibility. And finally, small companies often provide easier access to management, allowing us to talk directly with the decision-makers.

TWST: How did this area perform in the first half, relative to the overall market?

Mr. Deysher: It was a fairly volatile first half. The Russell 2000, our benchmark, rose 13%-14% in the first month of the year and then trended lower for the next several months before rallying again in late summer. Since then, the benchmark has trended lower. Through September 30, the index is up about 2.5%.

We expect this volatility to continue as investors process a variety of crosswinds impacting the market. We view volatility as our friend. When the market is trending lower, it allows us to buy stocks at lower prices and when the market is trending higher, we can sell at higher prices. So that's a key part of our philosophy — "buy low and sell high."

TWST: What kind of surrounding economic and stock market dynamics are usually most favorable to small cap value? Are you seeing anything that would signal an upturn?

Mr. Deysher: There are lots of crosswinds and lots of uncertainty in today's market. On the plus side, unemployment remains low and consumer spending remains robust. Artificial intelligence has jump-started a tech renaissance. The IPO market is starting to percolate with some fairly high profile offerings like **Instacart** and **ARM Semiconductor**. Market sentiment is fairly favorable which helps support the market.

On the minus side, we believe that interest rates will remain higher for longer, as the Fed tries to bring inflation under control. And some money market funds and CDs are paying 5%, an attractive alternative to equities.

Corporate profits have probably peaked for this economic cycle and will probably trend down over the coming quarters. Buybacks, which have been a key source of demand for U.S. equities, are declining as companies preserve cash in case of a recession.

And finally, the fallout from the recent banking crisis will likely continue, as credit standards tighten and banks pull back from lending to strengthen their capital ratios.

You've got lots of factors on the plus side, and lots on the minus side. So we'll see what happens as corporate profits and interest rates unfold over the coming quarters.

TWST: Give us a closer look at your fund, its structure and your strategy. What are the key factors you consider for including names in the Fund. And give us a view to your sector allocations and how you are currently positioned to meet with the dynamics you see evolving ahead?

Mr. Deysher: The Pinnacle Value Fund is an SEC-registered mutual fund that was launched on April 1, 2003 with a mandate to invest in small and micro-cap companies that we feel are undervalued relative to asset values or earnings power. Many of them trade below the radar screen of most institutions. We try to find compelling opportunities with big upside and minimal downside.

"One name where we got it right is a company called Daktronics, a Brookings, South Dakota-based maker and installer of electronic scoreboards and video displays. If you've been to a major sporting event or concert recently, you've likely noticed that electronic displays are getting bigger and more dazzling."

We generally target companies with strong balance sheets, capable management teams, attractive business niches, sound accounting practices and large insider ownership. We seek good companies at great prices, or great companies at good prices.

In terms of sector allocation, we really go where the opportunities are. Right now, we don't see any sectors that as a group are substantially undervalued. So we're putting our cash to work in individual names. But that could change depending on how the economy unfolds over the future months.

TWST: And if there's a recession? How would that affect this area?

Mr. Deysher: If there is a recession, most stocks will probably decline, including the stocks in our space because stocks are partly driven by earnings. They are also driven by p/e multiples which are influenced by interest rates. A recession is never good for the stock market, nor are inflation and higher rates. So we're tracking a lot of important variables.

TWST: Which names have done best over the past six months to a year. And why so? And if different, which names look best positioned for opportunity going forward?

Mr. Deysher: One name where we got it right is a company called **Daktronics** (NASDAQ:DAKT), a Brookings, South Dakota-based maker and installer of electronic scoreboards and video displays. If you've been to a major sporting event or concert recently, you've likely noticed that electronic displays are getting bigger and more dazzling. And **DAKT** is a major player there.

We bought the shares a year ago at $3, when the results were under pressure due to component shortages. And since then, the supply chain has normalized and sales rebounded. Shares are trading at $9 a share.

Another winner is **Powell Industries** (NASDAQ:POWL), a Houston, Texas-based builder and installer of electrical equipment for major capital projects such as pipelines, refineries, and mass transit systems. We've owned **Powell** shares for a number of quarters with an average cost of about $20 a share.

When we bought **Powell**, it was trading at a healthy discount to book value and yielded 5%. Over time, as energy prices rose, **Powell's** order book blossomed and earnings rose substantially. We've been selling shares at $40 and up. So this is a good example of a stock where we bought value and sold growth.

An idea that hasn't worked so far is **Gulf Island Fabrication** (NASDAQ:GIFI), a Houston, Texas-based metal fabricator. They've had a tough time transitioning from building offshore oil platforms to other opportunities following the decline in oil prices after 2014. They've got new management and are making progress, but they're still saddled with some unprofitable contracts and excess capacity.

Fortunately, the balance sheet is still in good shape and the shares, at $3.25, are trading slightly above the net cash per share of $2.60.

So those are a couple of examples where we got things right, and one where we didn't, at least so far.

TWST: What do you see for Daktronics and Gulf Island going forward? Are you lightening up?

Mr. Deysher: For both, we're lightening up. **Daktronics** exceeds our estimate of intrinsic value so we're selling some. **Gulf Island** has not performed as expected and, since it is a fairly large position for us, we opted to pare it back a bit.

When we're accumulating a position we're patient in waiting for the right price and try not to move the market. We're very gradual sellers as well. When we feel the risk outweighs the reward and the margin of safety narrows, we'll scale it back.

TWST: What have been some of your most recent buys? Where do you feel most confident about strong performance ahead?

Mr. Deysher: We've been buying three stocks recently. One is **Unifi** (NYSE:UFI), a Greensboro, North Carolina-based maker of texturized polyester and nylon yarns, used to make synthetic fabrics that go into apparel, home furnishings and automotive. Roughly 30% of their yarns are made from recycled plastic so it's an environmentally friendly company.

1-Year Daily Chart of Daktronics Inc.

Chart provided by www.BigCharts.com

However, sales of apparel and home furnishings have been weak recently and they've had trouble passing through raw material cost increases. Margins are under pressure, but the balance sheet is in good shape. Once they return to normalized earnings, the stock price should go up.

They also have two activist shareholders, who own greater than 5% each, so perhaps they can make something happen.

Another name that we've been buying recently is **Heartland Express** (NASDAQ:HTLD), a Des Moines, IA based truckload carrier. Post pandemic, the industry benefited from strong demand but now with demand returning to normal, margins and earnings are under pressure, hitting the share price.

"Hurco is also a net-net, a value investing concept pioneered by Ben Graham many years ago. It involves selecting stocks having a market capitalization less than net current asset value calculated by subtracting total liabilities from current assets."

They made two acquisitions that doubled their capacity which they're in the process of integrating. So there's lots of room for improvement once the cycle turns and they're paying down debt quickly.

We like companies like **Heartland** that increase capacity near the bottom of the cycle so they're well positioned for the upturn. The CEO has been buying shares, and the founding family owns 40%.

A third name we've been buying is **Hurco** (NASDAQ:HURC), an Indianapolis-maker of machine tool systems used to produce various types of capital goods. The end markets are cyclical and sales and earnings have been trending down recently. **Hurco** has been through down cycles before and their conservative balance sheet has always allowed them to emerge intact on the other side. The yield is almost 3% and there's no debt.

Hurco is also a net-net, a value investing concept pioneered by Ben Graham many years ago. It involves selecting stocks having a market capitalization less than net current asset value calculated by subtracting total liabilities from current assets. Hurco has a net asset value of $28/share — significantly above the current price of $21.

Finding quality firms like **HURC** trading at less than net asset value is extremely rare in today's market.

TWST: How important is it for you to meet with top management? Do you often have boots-on-the-ground to visit specific companies?

Mr. Deysher: Yes. Talking with management is an important part of our due diligence. Fortunately, with many small cap companies, there is often better access to top management, which we appreciate.

For virtually every stock in the portfolio, we've met with management either at their office or ours. We also have regular calls with them to make sure we're on top of what's happening. We like to tour plants and warehouses to see exactly how they operate. You can gain a lot of intelligence by walking the floor with a plant manager.

TWST: Have there been any particular management teams that have most impressed you? Which have most reliably borne out their forward-looking performance estimates?

Mr. Deysher: We look for a few things in management. Are they hands on, honest, intelligent, energetic and opportunistic? Do they act as owners not caretakers? Do they have a good grasp of strategic, operating and financial priorities?

That's why the proxy is so important; it gives details on compensation, share ownership and prior experience. We look closely at related party transactions which often indicate whether management is acting in the best interest of shareholders.

Assessing management is tricky. Sometimes the management teams that we had high hopes for are disappointing and other teams we thought were average turn out to be exceptional. Assessing management is just one element of our due diligence. Viable business models, strong balance sheets and other elements are also very important.

TWST: How do you mitigate against risk, if we are facing a number of headwinds going forward? Are you taking any steps to protect?

Mr. Deysher: Yes, we address risk in a few ways. First, we try to be diversified across multiple companies and industries. Currently, we own about 44 companies across 14 different industries.

We're very disciplined about what we pay for a security. We always ask what the downside is, then try to figure out the upside. As a wise investor once said, paying too high a price can turn an attractive investment into a mediocre one. We also stay with strong balance sheets that provide the ability to survive during challenging times.

And finally, we have the ability to hold cash in the absence of compelling opportunities. This allows us to harvest winners without the pressure to put the cash to work immediately in ideas that might not be compelling. Previously cash earned nothing, but now earns 5% in a government money market fund which may be an attractive alternative to putting cash back into the stock market.

1-Year Daily Chart of Unifi Inc.

Chart provided by www.BigCharts.com

TWST: So, are you holding greater cash levels than usual, compared to maybe a year or two earlier?

Mr. Deysher: Yes, we are holding more cash simply because we've taken profits in a lot of names that we bought during the lows of the pandemic. They've worked out well and now trade at or above our estimate of intrinsic value. We'd like to put the cash to work and are looking diligently for opportunities.

Holding lots of cash is not a market timing move but a consequence of the absence of compelling opportunities. We'd like to bring it down as soon as possible.

TWST: Going forward, what are your biggest worries? What keeps you up at night? And where might you be seeing any silver linings?

Mr. Deysher: We have a few concerns. While we can't predict where the economy or interest rates go, we do think about the consequences for the stock market. Whether the Fed can engineer a soft land remains to be seen. Our $33 trillion national debt may have some serious consequences at some point.

We're also concerned about the amount of financial leverage embedded in the system as a result of low interest rates. Many firms have variable rate debt that ratchets higher with each uptick in interest rates. Bankruptcies are at their highest level in a decade and we expect more to come.

We're also challenged by the proliferation of competitors like private equity, venture capital and hedge funds. Many have large pools of capital to put to work and are often willing to pay higher valuations for public companies than we are. Our universe of investable public companies has declined dramatically over the years since many have been acquired by strategic or financial buyers.

It's also increasingly difficult to get proprietary information that no one else has. We work hard at this, but the internet has really levelled the playing field so it's a challenge. That's why maintaining a strong relationship with management is so important.

The only silver lining is that with higher interest rates, many potential deals may not generate the returns necessary to justify an investment. We also think prospective buyers — strategic and financial — are thinking carefully about how a potential slowdown might impact future earnings. So going forward this might trigger a reset in valuations that allows us to accumulate positions at reasonable prices.

So, we'll stay conservative and let valuations be our guide. We have a universe of 100-plus companies we've done the work on and want to own at the right price. At some point there will likely be a disruption of some type that will present opportunities to put our cash to work. While we think about the economy, we try to focus on events that impact the stocks we own or would like to own.

TWST: Your concluding thoughts? Anything else you think potential investors should know, specifically about investing in your fund?

Mr. Deysher: Sure, we tell investors we'll make four promises to them. The first is that, despite our best efforts, we will make mistakes. We'll try to keep risk to a minimum so the damage is not too great. Second, we will invest on the basis of value, not popularity. We often take a contrarian approach and try to identify what the crowd may be missing. Third, we'll be disciplined in style and execution. No style or market cap creep, we focus on high-conviction ideas we know well. Our fourth promise is that our family will have a substantial personal investment so our interests are aligned with our shareholders.

TWST: Thank you. (VSB)

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