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Questioning Market Leaders For Long Term Investors

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ANALYST INTERVIEW

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ANALYST INTERVIEW

Investing in Undervalued Small Cap Companies

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JOHN E. DEYSHER is President of Bertolet Capital LLC, advisor to the Pinnacle Value Fund, a diversified, SEC registered mutual fund. He is responsible for the Fund's daily investment activities and has over 20 years' experience in the investment management business. From 1990 until late 2002, Mr. Deysher was a Portfolio Manager and Senior Analyst with Royce & Assoc., an investment firm specializing in the securities of small cap companies. 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 Indiana University, Bloomington (Business) and University of California, Berkeley (Science). He is a Chartered Financial Analyst.

SECTOR – GENERAL INVESTING (XAP903) TWST: Can we start with an overview of the Pinnacle Value Fund?

Mr. Deysher: The Pinnacle Value Fund was launched on April 1, 2003. Its mandate is to invest in securities of small and micro-cap companies that are undervalued and trade below the radar screen of big institutions. Our prospectus says we invest in market caps $1 billion or less, but we can go bigger than that for the right opportunity. We are deep discount value investors and seek out the most compelling opportunities with the biggest upside potential and the smallest downside risk. The keys to the companies we look at are strong balance sheets, big insider ownership, the ability to generate strong returns on capital and cash flows, and capable, owner-oriented management.

TWST: Where do you come up with the names?

Mr. Deysher: They come from a variety of sources. We do a lot of proprietary screens using variables that are important to us like p/e's, price to book ratios, dividend yields, etc. We look at SEC filings of what insiders and major investors are doing. We exchange ideas with a solid network of micro-cap and small cap investors who think like we do. We talk with trade and professional associations about member companies that are solid players in their industry. We look at the new list every day which often presents some interesting opportunities. So we get ideas from a variety of sources.

TWST: I didn't hear much about Wall Street in there.

Mr. Deysher: Well, to be honest, a lot of our companies are so small they don't have coverage. We view that as a plus because less coverage means less competition and the potential for a security to be inefficiently priced and undervalued.

TWST: Do you concentrate on specific sectors?

Mr. Deysher: We are generalists, so wherever the opportunities are, we go.

TWST: What is the appeal of looking at the ones that don't get much attention?

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Mr. Deysher: They can be significantly undervalued because few investors are looking at them. As you know, the Russell 2000, our benchmark, has regained all of the ground lost in the last bear market and is trading pretty close to its high now, while the S&P and the Dow are still 25% to 30% below the highs set several years ago. There are lots of bright people and lots of money chasing small cap names. The appeal is to have them below the radar screen, do the due diligence required and then accumulate them before the rest of the world catches on.

TWST: Are these big enough that you can take a meaningful position?

Mr. Deysher: Sometimes yes, sometimes no. We are very disciplined in terms of the price we are willing to pay. We do the work and then we figure out, "Okay, what's our buy trigger and what's our sell trigger?" Of course, those are dynamic figures, they move around depending on the prospects of the company. But we'll start to nibble when a stock trades down to our buy price, and if more stock comes in, we may back off a bit. But if we've done the work and have the conviction to know that the stock is undervalued and reasonably priced, we'll take a large position, sometimes as high as 5% of the portfolio. For other stocks, only 100 shares might trade at our buy trigger so we may only be able to buy a small position.

TWST: Have you set the criteria that you use when you look at companies, in terms of ROI or margins?

Mr. Deysher: We look at several criteria, some are quantitative as you just mentioned: returns on assets or capital, free cash flow generation, margins, asset turnover. We look at all those, but we also look at qualitative aspects such as the talent and vision of the CEO. We do a lot of homework on the CEO's background, especially for a company that's new to us. What has the CEO done historically and why is he or she best suited to the job? We'll look at the competitive landscape and how strong the competitors are. We'll look at major customers and vendors to assess who has the bargaining power. Finally, we'll look at governance issues and go through a checklist to make sure management is on the same page as we are, governance-wise.

TWST: Do you spend a lot of time with management?

Mr. Deysher: Enough. We participate in the quarterly earnings conference calls most companies have. We'll also have discussions off line as frequently as needed if we're concerned about particular issues. Conversely, if a stock is tracking the way we think it should, then we'll just participate in the quarterly conference calls. But if there's something troublesome, we will get on the phone and find out what's up.

TWST: Do you find much competition in this space at this point?

Mr. Deysher: For our market caps?

TWST: Yes.

Mr. Deysher: Absolutely. There are lots of mutual funds that launched small cap product over the last couple of years. There are many hedge funds that are trolling in this type of merchandise. Yes, there is a lot more competition right now.

TWST: Does that make it tougher or is the universe big enough that you don't bump into each other?

Mr. Deysher: It makes it tougher. You really need the Russell 2000 to collapse and shake out some ideas. A couple of weeks ago, when the Russell was in a downdraft, we put a fair bit of cash to work. People got scared and sold some stocks that we were able to capture at decent

prices. There are about 6,700 companies with market caps under $1 billion so our universe is pretty big, but I would say 98% of that universe is fairly priced right now.

TWST: So it kind of limits the opportunities?

Mr. Deysher: Right now, yes. But we are still finding a few opportunities at acceptable valuations.

TWST: Do you tend to stay fully invested?

Mr. Deysher: No. We've written into the prospectus that we have lots of latitude on what percentage invested we can be. Right now, we are about 60% invested and 40% cash. That is more of a function of not being able to find appropriately priced merchandise. We don't have a mandate to be fully invested.

TWST: What are one or two of your favorite names at this point?

Mr. Deysher: You mean in the financial sector or in general?

TWST: Let's look at the financial sector since that's what we are focusing on at the conference.

Mr. Deysher: We view the financial sector as being four primary areas: the banks, thrifts, insurance companies and brokerage firms. All four have done very well with the decline in interest rates over the last couple of years. The only area approaching being undervalued are the brokerage firms. Some were making new lows a couple of weeks ago. One of the bigger cap names we like is **A.G. Edwards** (AGE) a well-run full service brokerage firm founded in 1887. They have cost-conscious management, maintain a conservative balance sheet, and earn nice ROEs over time.

TWST: How does that fit in with your size criterion?

Mr. Deysher: A.G. Edwards is a $2.6 billion market cap, and that's bigger than we normally buy. However, we have the flexibility to go above the billion dollar mark if required. A couple of other names in the space would be **Knight Trading** (NITE), a big ECN, and **SWS Group** (SWS), known as Southwest Securities, which is strong regional firm with a major clearing presence.

TWST: First you look across the financial sector and determine which segment looks appealing and then you go and find names?

Mr. Deysher: Yes, exactly.

TWST: What is it about Southwest Securities that attracts you there?

Mr. Deysher: We like **Southwest**, which has a $270 million market cap, for a few reasons. One, it has a big insider ownership with the Chairman, a fellow named Don Buchholz, owning 10%. So they come to the office every day with their wallets on the line. Second, they have a major presence in clearing, which is handling the back office trades for firms that don't have their own in-house clearing. It's a competitive business tied to trading volumes but it is generally more consistent than corporate finance, which can be volatile depending on the level of merger and acquisition or financing activity. They also have a nice commissions and trading business that generates nice returns on capital. The shares tend to bottom at 60%-70% of book value and, if you can buy at those levels, you'll normally do okay.

TWST: Do you have a time horizon of a couple of years?

Mr. Deysher: Yes. We normally invest at the time horizon of two to three years.

TWST: The other side of the buying decision is the selling discipline. What causes you to get rid of a stock?

Mr. Deysher: There are four reasons that cause us to sell a stock. First is if it hits our sell target which we adjust accordingly as fundamentals evolve. If a stock gets overpriced or gets ahead of itself, we'll probably take some money off the table. Second is if we make an error in judgment, reasoning, fundamental analysis or we miss something and are wrong. Normally we're not hurt too badly because when we start buying an idea, we'll buy it gradually as we get to know the company, how it trades, how management thinks. So, if we're wrong, we normally discover that fairly early and the damage is not too great most of the time. Third is if we find a better idea. A company doesn't quite reach its sell point but another idea is so compelling that we sell the first idea to put the proceeds into the second idea, which is much more undervalued. Finally, if we buy a company and the reasons we have for owning it don't unfold over a two- or three-year period and the fundamentals aren't improving, we'll normally liquidate it and move on. However, if the fundamentals are improving and the stock price is stagnant, we'll continue to hold it because eventually the stock price will catch up.

TWST: The other name you mentioned was Knight. What's the appeal there?

Mr. Deysher: Knight, with a $1 billion market cap, is a major presence in electronic trading, handling about 15% of all NASDAQ-listed share volume. The industry is probably ripe for consolidation, and indeed there has been some consolidation in the past. They are one of the low-cost providers of electronic trading and have a very strong balance sheet, which is essential to get them through the inevitable lulls in the business. They own 50% of asset manager Deephaven, a hedge fund group that manages $3.2 billion in arbitrage type strategies. They also own 7% of International Securities Exchange options market which is about to go public. CEO Tom Joyce has done a great job at rationalizing the business over the last few years.

TWST: The first name you mentioned was A.G. Edwards, which you just said was kind of outside your size parameter.

Mr. Deysher: Yes. It's a bit big for us but **A.G. Edwards** is a well-known name with a strong balance sheet and a Main Street retail focus that is less vulnerable to price pressures than institutional brokerage. **A.G. Edwards** has some banking business but not a lot so they are less vulnerable to swings in that type of business. Over time they have delivered for their shareholders with a 1.8% yield offering solid total returns.

TWST: Because they have been very consistent over time.

Mr. Deysher: Exactly.

TWST: Don't tend to get into trouble.

Mr. Deysher: Yes, exactly. You rarely see their name on the SEC list.

TWST: They have once or twice, but it is the exception rather than the rule.

Mr. Deysher: True, exactly.

TWST: How about the other sectors of finance at this point?

Mr. Deysher: The banks, thrifts, and insurance companies have all done well. One of the things we look at is how the indices have done. We track the Value Line bank index, thrift index, and insurance index, and all of those indices have doubled or tripled over the last couple of years. Why is that so? Interest rates came way down, which means banks and thrifts were able to generate loans, mostly consumer loans with some business loans. They were able to sell those loans in many cases for nice profits. They were able to capture the fee income that was generated by those loans. In many cases if

they held stock or bond portfolios and did very well on the investment side as well. So, in our mind, banks and thrifts are fairly priced now.

TWST: What would cause you to change your attitude? Maybe a pullback in pricing or a change in fundamentals?

Mr. Deysher: Either one of those. If stock prices came down, that would be attractive to us. We've got a laundry list of probably 200 or 300 names in this space, all of which have buy and sell triggers based on the fundamental work we've done. So if the prices came down, that would work. But I think what is going to happen is, if rates continue to go up, there is going to be some pressure applied to these types of firms because a lot of borrowers have variable rate loans and if rates go up, there is going to be some pressure on those borrowers. I think the risk of default is going up and there are going to be some charge-offs and increases in non-performing assets. The second thing that happens with higher rates is people are going to borrow less and fee income on loans generated is going down. There will also be fewer loans to sell, and gains on sale will be tougher in an increasing rate environment. Banks and thrifts are in that spread game, and in a rising rate environment you don't want your deposits (liabilities) maturing faster than your loans (assets). You don't want your interest expense rising faster than what you have coming through the door in terms of interest income.

TWST: And we have seen them get caught before.

Mr. Deysher: Yes, exactly.

TWST: How about on the insurance side? The insurance business seems to have come in for a little flurry of interest here.

Mr. Deysher: Yes. In the wake of 9/11, insurance rates hardened across the board. They went up, and the insurance companies were able to generate nice earnings from those rate increases, balance sheets got better, insurance companies did secondaries and in some cases primary offerings. Recently, a lot of capacity has entered the industry especially on the property and casualty (P&C) side. You are seeing premium rates coming down on the P&C side by 10%-20% and as rates come down, profit margins decline. If interest rates go up, stock and bond prices are going to come down as well. So insurance companies could get hit with a double whammy both in terms of their operating business and their investment portfolios.

TWST: Wasn't there some hope that, with the hurricane, rates might harden a little bit?

Mr. Deysher: Yes, that's true. That's always the wish of insurance companies. Yes, you mentioned there has been a flurry of activity. I think people are looking at that, no doubt about it.

TWST: But not tempting yet?

Mr. Deysher: Not tempting yet. You look at them and they are all trading at, or at least the good ones are all trading at nice premiums to book and fairly robust p/e multiples. They're not where they were several years ago when they really were cheap.

TWST: Have to wait for the cycle to change?

Mr. Deysher: Perhaps, yes.

TWST: Thank you. (TJM)

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