Mutual Fund Manager of the Year

Pinnacle Value's Deysher puts Buffett strategy to work in small caps

By Jonathan Burton, MarketWatch
Last update: 7:15 p.m. EST Feb. 4, 2009

SAN FRANCISCO (MarketWatch) -- While many price-conscious investors regard Warren Buffett as a living patron saint of value-stock buyers, John Deysher has built something of a shrine to the Oracle of Omaha.

Deysher, manager of Pinnacle Value Fund (PVFIX) , trolls the same ponds where Buffett is fishing, but he focuses on shares of small-cap and microcap companies with the cheap valuations and solid business characteristics that hook bargain-hunters.

John Deysher.

And so no one misses the connection, Pinnacle Value's Web site links to Berkshire Hathaway Inc.'s (BRK.A) (BRK.B) Internet home page and Buffett's folksy-but-frank shareholder letters.

Buffett is just one source of ideas in Deysher's broad, multitiered investing strategy, which relies extensively on gumshoe research that allows him to be a contrarian and patient shareholder. His independent approach cushioned Pinnacle's shareholders from the bitter extremes of last year's market meltdown and has brought chart-topping gains over the past five years.

Such flexibility and openness are crucial in challenging investment climates like this, where fund managers must stick to their discipline while navigating new and unfamiliar currents. For those reasons and more, Deysher is the winner of MarketWatch's Mutual Fund Manager of the Year award for 2008. See how the previous three winners have fared.

Deysher's eye for the little details has kept Pinnacle Value at the top of its small-cap value category most of the time since its April 2003 launch. That made a big difference in 2008, when the average small-cap value fund tumbled 32%. Pinnacle lost ground last year too, but its 16.9% decline left shareholders -- including Deysher -- with almost twice as much money in their accounts as they would have had in many rival funds.

Of course, you could have made a bundle last year in a short-selling or bear-market fund. But MarketWatch's fund manager award has never been about short-term performance. Because those types of funds are not appropriate for average investors, they are not included in the screens MarketWatch uses to choose its fund manager winners. Those winners have delivered long-term, market-beating results, with careful attention to risk, expenses and taxes. See how MarketWatch chose its Fund Manager of the Year.

Deysher is no exception. "Last year was really tough for most small-value funds and really treacherous," said Russel Kinnel, director of fund research at investment researcher Morningstar Inc.

But Pinnacle Value finished in the top 1% of its peers in 2008, as well as over the past three years and five years, according to Morningstar. Its three-year 2.8% annualized gain dwarfs the category's 9.6% average loss, and its 7.1% annualized return over five years far outpaces the small-value group's average 1% yearly decline.

Put another way, a $10,000 investment in Pinnacle Value at the end of 2003 would have been worth just over $14,000 five years later. The average small-cap value fund, meanwhile, would have left you with about $9,500.

Moreover, Deysher produced those returns with an eclectic portfolio that reflected less than half of the market's risk. The $56 million fund holds 55 stocks but last year kept about half of its assets in cash, which certainly helped smooth the ride. Deysher is no market-timer, however. He just couldn't find many stocks that fit his strict criteria. But nowadays, Deysher is putting cash to work.

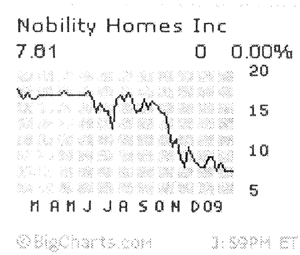
"People who have done their homework and are stepping up will be rewarded over a couple of years," Deysher said. "You never know for sure, but you can tilt the odds in your favor if you've done the homework and buy at a reasonable price."

Risk controller

Deysher is proof that you can learn a lot by watching. For example, Deysher studies what Berkshire Hathaway is buying and tries to find smaller companies in those industries with Buffett-like qualities.

"He's the master," Deysher said of Buffett. "If you have to look to one investor who has a superb long-term record in place, who plays piano with all 10 fingers, you would look to Buffett."

So when Buffett invested in manufactured housing and recreational vehicle manufacturers, Deysher surveyed those markets and found compelling values in Nobility Homes Inc. (NOBH) and, in the RV business, Thor Industries Inc. (THO) .



Sales of manufactured homes are at their lowest in a decade, but the sector typically rebounds quickly from depressed property markets, Deysher said. "It's cheapest, people can qualify for it, and it's no surprise that Buffett is involved in this space," he added.

In both Nobility Homes and Thor Industries, Deysher sees companies with strong market share and sharp management that knows how to weather a downturn and prosper when business picks up.

"The fund is designed to appeal to someone who is interested in owning well-capitalized small companies, who is looking for capital appreciation first and income generation second, and who is seeking alternatives to more conventional investments," Deysher said.

"Yes, we're contrarian," he added. "We look at industries that are out of favor and try to find the best companies, the survivors."

Deysher, 53, became a devotee of Buffett in the 1980s, when he was a stock broker at Kidder Peabody. But it was another famed value investor, Chuck Royce, who hired the plain-speaking Pennsylvania native as a stock analyst and portfolio manager and taught him to apply his research skills to undervalued small companies.

Deysher managed money at Royce Funds for 12 years before leaving to start Pinnacle Value. (He didn't go far -- Deysher's Manhattan office is a couple of floors below Royce's firm, and Royce is an investor in Deysher's fund.)

Said Royce of Deysher: "He's a superb analyst. He's a very serious, deep-value person who is ultimately concerned with balance sheets and margin of safety. Risk is really what it's all about -- trying to understand how much you can lose, not necessarily how much you can make."

Investigative techniques

At Royce, Deysher honed the deliberate investment approach he uses today -- designed to ferret out shares of high-quality businesses trading at a discount to Deysher's estimate of their true value. His ideas come from many corners: investment screens; new-low lists, regulatory filings. Then, Deysher digs into the financial statements of both the company and its competitors, and talks to industry associations and trade magazines.

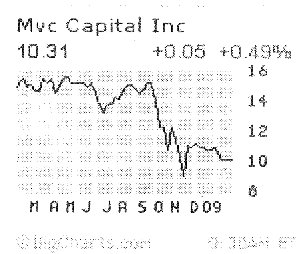
His goal: to reduce reams of information about a company to several "critical issues" -- essential strategic and operating concerns that confront corporate managers. It's a key part of the process that Royce always preached, Deysher said.

"If you can identify the four to six critical issues," he said, echoing Royce, "then you can have a discussion with management in terms of how they are addressing those critical issues."

Meeting with a target company's management is paramount. Executives may not want to discuss critical issues, or maybe they'll tell all, but either way it's a conversation that Deysher must have before he'll buy a stock.

"A manager has to have an owner's knowledge of the business, even if they're not the owner," Deysher said. "They have to show some energy and the ability to manage well."

Comfort with management led Deysher to invest in the fund's largest holding, MVC Capital Inc. (MVC) , which itself buys the private equity and debt of several dozen diverse companies, including auto dealerships in Eastern Europe and a marine park in Florida. Deysher praised MVC Chairman Michael Tokarz, noting that "over the last several years he has earned very attractive rates of return for his shareholders."



Valuation, in fact, is the last piece. Said Deysher: "The stock is bumping along the bottom, maybe trading at a discount to book value or at a low price-to-earnings multiple. It may be losing money. Our job is to get in there and say 'the stock is down, is that permanent or temporary?' If it is indeed temporary, how do we exploit it?"

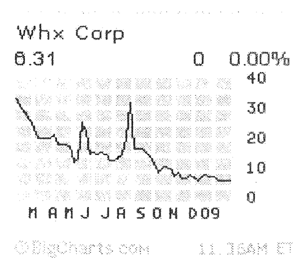
Niche player

Critical investment and shareholder issues guided MarketWatch's search for its Fund Manager of the Year. Deysher aced a test in which about 5,200 U.S., global and international stock-funds were judged on performance, expenses and tax efficiency.

Of that group, just 17 managers made the cut. Ironically, one of Deysher's rivals was former Royce colleague Charles Dreifus of Royce Special Equity Fund (RYSEX) , who was Morningstar's 2008 Domestic-Stock Manager of the Year.

Deysher won on the strength of long-term results, consistent risk management, and a visible concern for shareholders in the form of below category-average expenses and above-average tax efficiency.

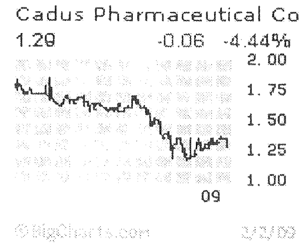
In addition, Deysher has a welcome transparency in his shareholder letters, highlighting not only Pinnacle Value's winners, but its losing "sinners" -- such as conglomerate WHX Corp. (WXCO) , about which Deysher lamented his "terrible" timing.



"We try to be honest with our shareholders," he said. "That's one of the things they hire us for."

This year, Deysher is trying to be honest about what the market can realistically deliver. He's sticking with the niche opportunities he's found among small banking companies serving predominately ethnic customers, such as Los Angeles-based Preferred Bank (PFBC) , which addresses the Chinese-American community.

Deysher also is pursuing a unique strategy that involves shell companies with sizable cash stakes and net-operating-loss carryforwards. Cadus Pharmaceutical Corp. (KDUS) is an example.



The thinly traded holding company has no significant operations, but it does have plenty of cash -- and its shares trade at a discount to that value. Deysher said he expects Cadus to use its cash to acquire a company, the earnings of which would be tax-free as the NOLs are absorbed.

Companies like Cadus are "lottery tickets," Deysher said.

"Some of them will work, some of them won't," he added. "But at current prices we don't have much downside."

Aspiring value investors, take note: That's how you bend it like Buffett.

Jonathan Burton is an assistant personal finance editor for MarketWatch, based in San Francisco.

Feb. 4, 2009