A SEARCH FOR OUT-OF-FAVOR STOCKS AMONG THE LARGE- AND MID-CAP MARKETS

FUND FACTS

T. ROWE PRICE VALUE FUND (TRVLX)

CATEGORY:
Growth

PERFORMANCE: (thru 3/31/99)

Compound Annual Return (%)	Fund	Category
1 Year	–1.2	6.1
3 Years	18.7	18.9
5 Years	na	18.8

RISK: (relative to category)
Below Average

TOTAL ASSETS: (as of 5/31/99)
$920 million

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In the past few years, the top-performing mutual fund lists have been dominated by funds that focus on a large-cap growth approach. If you were to select funds from these lists, you would most likely exclude funds that focus on other sectors of the market, most notably funds that use a value approach, and those that invest in the mid-cap or small-cap sectors of the market.

One value-based fund that has performed well relative to other value funds is the T. Rowe Price Value fund. Over the last year (through March 31), the fund's return was –1.2% compared to a return of –2.4% for the average value fund; over the last three years it returned 18.7% compared to 15.9% for the average value fund. [Mutual fund performance by category and style was discussed in "Mutual Fund Classifications: How Do Your Funds Fit In?" by John Markese in the June 1999 issue of the AAII Journal.*] The fund invests in both large-cap and mid-cap stocks; currently is has about $920 million in total assets.*

Although it has a shorter-term track record (it was started in 1994), it is managed by Brian Rogers, who also manages the T. Rowe Price Equity Income fund, which has a long-term record and focuses on large-cap value stocks.

Mr. Rogers discussed the management of the fund with Maria Crawford Scott in late May.

What is the investment objective and philosophy of the fund?

The value fund has growth of capital as an objective; income is a secondary consideration, although more income is better than less income if we find it. It is meant to be a classical conservative value fund that looks for undervalued securities, which will tend to be mid-sized to large in market capitalization (share price times number of shares outstanding).

Basically we try to identify companies that have contrarian appeal, in the hope that one or two years down the road, investors will view it differently than they view it today.

What size companies do you typically invest in?

We always have a few smaller companies, but the bulk of what we do is with companies around $2 billion and above. Over the life of the fund, which goes back to 1994, we've had investments in everything from a $1½ billion bank all the way up to AT&T.

How do you identify potential companies? Do you use various valuation screens?

Yes, we screen for companies with historical anomalies, and by that I mean companies whose relative valuation in the marketplace today is cheaper than it normally is—for instance, a company that normally sells at a 10% premium price-earnings multiple and today sells at a 25% discount price-earnings multiple.

Price-to-cash flow is a little more difficult to screen for—you really have to look at that on a case by case basis, which we do. Looking at relative dividend yield patterns, on the other hand, is easy. But basically we're looking for those earnings, dividend, and cash flow streams that are mispriced.

A classic example earlier this year would have been a chemical company before the cyclicals rebounded in April. It is temporary situations like that

that we seek, and of course part of our bet is that they are in fact temporary. We are trying to be counter-cyclical in terms of investor psychology.

Do you factor future earnings growth rates into the valuation equation?

We factor growth rates in, but that is a little less important because I am personally very skeptical that we can forecast growth rates. When I look at earnings growth forecasts, I always take them with a grain of salt because so often they are a simple continuation of what the company has already experienced. There has been a fair amount of academic work that has demonstrated how tricky it is to try to forecast earnings with any degree of reliability. I think you can do it with Procter & Gamble; I don't think you can do it with DuPont, not to mention companies that are even more cyclical.

We view the market as dealing us a hand of cards, where we only really know where things trade today relative to where they have historically, and we try not to make big assumptions about earnings growth going forward. What we are willing to bet is that, in situations where the market has over-discounted, the company will revert back to its historical earnings and dividend growth pattern.

An extreme example of this occurred in some of the cable TV companies a couple of years ago—for instance, Comcast, which was an investment of ours in 1997. For a time, it was viewed as being a very much out-of-favor sector with limited growth prospects and a big risk of technological obsolescence. But you could see looking back in time that investors viewed it very differently at different periods.

The one thing that we're trying to identify is periods when companies appear to be under pressure, and perhaps they've just had poor relative price performance over the last year. We have to be willing to take a leap of faith that at some point in the future, they will be loved again. Companies that investors have loved at one point in time are often loved again. We always talk internally in terms of companies with a high 'lovability' index. I put some of the media companies in the midst of that—Viacom was a very good investment for us in the last couple of years, although we've since sold it.

Is it usually fairly obvious why a company has fallen out of favor?

I think it is very easy to figure out why companies are in the pickle they are in. What is hard is to create a scenario in which it will return to favor.

What do you look for that will create a favorable scenario?

My experience is that the market will tend not to let glaring valuation disparities exist forever. So, sometimes we will make an investment if we are convinced that basically it's a decent business and there is no more downside left, even though we don't see exactly what's going to make it improve.

In addition, there are always interesting things going on in corporate America that fall more into the category of behavioral finance and market dynamics. For instance, so many boards of directors now are under a lot of pressure to improve the performance of their companies, and so you have been seeing a lot of M&A (mergers and acquisitions) activity now. Generally, this activity will focus on larger, more prosperous companies trying to buy smaller, perhaps undermanaged companies.

One recent example is our investment in Raychem, which makes a lot of specialty chemical products that go into the manufacture of electrical components, semiconductors, things of that nature. If you had bought it at the end of 1997, you would have paid $50, but by the beginning of this year it was at $25. Obviously at $25, as we looked at the same earnings and cash flow streams, it was a cheaper security than it was at $50, and was attractive to us. A couple of weeks ago, Tyco came in and bought the company, and will pay in the upper $30s to acquire it.

What goes into your actual valuations?

We have extremely soft valuations of what we think companies are worth. They are soft because I can't say that if Raychem was selling for $25, it was really worth $42. But I can say that under $30, it looked attractive and potentially had a value of between $35 and $45, and going from $25 to something in the $35 to $45 range is at least a year's worth of performance. And we always have back-of-the-envelope assessments of what we think a company is worth, but at the same time an awful lot of it is relative to everything else. If the market went up 50%, then arguably Raychem would be worth a lot more, and conversely if the market went down 20% while Raychem held at $25—it didn't change in price—that would make it less attractive.

Does your approach cause you to be more concentrated in particular industries?

We are fairly well diversified—for example, right now we have 95 stocks in the fund. And we are reasonably diversified by sector, but at the same time we don't have a lot in the way of Internet companies. We are underweighted in technology right now, although what's happened to some of the software companies, except Microsoft, makes me think that there could be some pretty interesting values emerging in that sector.

If you look at whatever sectors have been the weakest over the last one or two years, that's probably where we will be spending more time. Conversely, whichever sectors have been the strongest, we will probably be somewhat underweighted in.

Many articles discuss "growth" stocks and "value" stocks. Would you buy something that is considered a "growth" stock if its share price suddenly tumbled—Microsoft, for instance?

Yes, although the way we would view it, Microsoft would have to fall pretty far for that to be the case.

Better examples are some of the companies in our top 20 holdings list: Browning-Ferris, Hewlett-Packard, Toys R Us, Seagram, CBS Corp., Motorola, and Raychem. These companies would have been viewed as growth companies at one point, but after they disappoint and go down, they are no longer considered growth companies, so you have a transition among who owns them. A growth investor might sell them and people like us come in and try to buy them when the price looks attractive. I would argue that the vast majority of companies are sometimes viewed as growth companies and sometimes viewed as value companies.

Why have value stocks fared so poorly in recent years?

When you go back over time and look at the data provided by investment consultants, you find that 1998 had the biggest growth/value spread since they started tracking this stuff back in the 1970s. I think a lot of it is that there was better earnings momentum among growth companies—they looked to be safer havens in the context of an environment that at least in the second half of the year looked quite fragile. At the same time, you had a technology frenzy. A lot of those stocks went up, in my opinion, to outrageous levels, but they did have good earnings performance—it wasn't as if there was no justification for it. You also had only narrow breadth in the market—the top 20 companies provided a very large component of the broad markets returns. I think all of those things basically help explain why value did not do well.

What about the fund's cash position?

The cash position since we started has always been between basically 2% and 10% of assets, and right now we are 7% to 8% in cash because, surprisingly, we are getting cash inflow.

Generally we have not made big market timing bets in terms of the fund's cash position.

What would prompt you to sell a stock?

One big reason would be if the misvaluation we identified, which caused us to buy the stock, corrected itself. A good example is Comcast. Investors eventually came back to cable, and also viewed the company as a potential acquisition target. Over that period of time Microsoft made an investment in the company, which seemed to validate, in our view, that the company was a decent competitor. We sold Comcast because we felt sentiment had changed, the relative valuation had deteriorated and there were other things around that looked more attractive.

Do you ever discover that you made a mistake in that a company is just not going to be rediscovered?

Yes, that happens. A company we sold recently, Occidental Petroleum, we basically gave up on. There were so many other interesting opportunities in the energy sector, and we had owned this for some time. Basically we bought it at $20 and sold it two or three years later at $20, with it having traded between $15 and $25 in the interim. It never looked expensive enough to sell.

This is an interesting example because usually, if an investment is bad for us, we don't tend to lose much money. The price for investing in the technology sector is that you have the potential to quintuple your money, but also the potential to lose 75% of it. In our world, we have the potential to double our money, and the risk that maybe we'll lose 10% or 20%. The downside in our typical company isn't that great, and the upside isn't open-ended. I mean, there are limits as to how far Georgia-Pacific can go up.

Often when the market hits new highs, as it has recently, many value investors say they are having trouble finding value. But it sounds like you're not having any trouble at all right now.

No, and that is primarily a function of how narrow the market was, where in 1998 the S&P was up 29%, but the average stock on the NYSE was up only 4% or 5%. If you venture down into the mid-cap and small-cap sectors, the average stock was actually down last year. It is that type of very concentrated performance that mathematically suggests a lot of stocks, especially the small caps and mid caps, are relatively mispriced.

And what is the scenario for those sectors to come back?

I think it would come back in the context of the high-fliers getting penalized, and we may have seen some of that over the last four or five weeks. And it would come back in the context of investors responding to better relative value.

The other provocative development is that it would not take much money transferred out of a Merck or a Cisco to help fuel a small-cap rally. The valuation fixation on some of the high-fliers has been so dramatic and the capitalizations have become so extended that if a couple of large mutual funds decide they want to eliminate a small amount of their large-cap exposure, it will have a magnified impact on anything small cap that they may want. In other words, it would take 1% coming out of the Magellan fund hypothetically to start a small-cap rally. I think that is the kind of thing that could ultimately happen. ✦