A BOTTOM-UP VALUE APPROACH LOOKS FOR MID-CAP STOCKS THAT CAN MAKE THE GRADE

FUND FACTS

MARSHALL MID-CAP VALUE (MRVEX)

CATEGORY:
Growth & Income

PERFORMANCE: (thru 9/30/01)

	Fund	Category
Compound Annual Return (%)		
1 year	10.8	(11.6)
3 years	12.7	4.9
5 years	12.0	9.2

RISK:
High

TOTAL ASSETS: (as of 10/1/01)
$175 million

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While the stock market has recovered from its low following the terrorist attacks, it is still down considerably from the beginning of the year. Yet value stocks, along with some of the mutual funds that use a value approach, continue to be the silver lining in the dark stock market cloud.

One fund that has retained its value and even added some through the market fall is the Marshall Mid-Cap Value Fund. The fund has managed to keep its head above water since the beginning of the year, with a return of 2.4% (through October) compared to a loss of 11.7% for the average growth and income fund. The fund is among the top 25% of all growth and income funds for the last year, three years and five years.

Currently the fund has about $175 million in total assets.

In early October, portfolio manager Matthew B. Fahey discussed the management of the fund with Maria Crawford Scott.

What is the investment philosophy of the mid-cap value fund?

It's a value fund that concentrates on mid-cap stocks. We pursue stocks one-at-a-time, looking for those that are temporarily out of favor.

And we are basically always fully invested in the stock market—no market timing, which I simply have no talent to do. If there's cash in the fund, it's because we've just sold some stock or because we've gotten cash inflows in and we haven't invested it yet. But cash is almost always between zero and 10%.

What qualifies as a "mid-cap" stock, and why do you focus on that area of the market?

That's a moving target, isn't it? Right now, we are looking at companies with market capitalizations [share price times number of shares outstanding] of between $1 billion and $10 billion. These stocks are similar in size to the S&P MidCap 400, or the Russell Mid-Cap Value indexes.

This fund invests in mid caps because we, at the Marshall Funds, want to give our investors the opportunity to participate in different parts of the market, so we have funds that focus on different market segments.

Why do I personally enjoy mid caps? I think mid caps give you the best of both worlds—you have managements and companies that are more seasoned than small-cap firms, yet they still have room to grow and they may still be undiscovered.

What are the primary screens that you use to find undervalued stocks?

We use a variety of screens, including price-earnings ratio, price-to-sales ratio, price-to-book ratio, and price-to-cash-flow ratio. However, screening is just one of our tools. Quite frankly, we probably find more ideas outside our screening process than within the screening process, because a lot of times a value stock may not screen well.

In terms of looking for value, we have three categories: We seek attractively valued stocks, we seek stocks that have unappreciated assets within their ownership, and we seek company turnarounds. That third category is one that you can't really screen for. Basically, a company that was doing well stumbles and is doing less well than it was previously, and we investigate it to see if it can turn things around and get back to its old tricks. And really it is difficult to screen for unappreciated assets. So out of the three methodologies, you can really only use some screens for valuations.

Of the stocks that we own, those that are undervalued due to unappreciated assets would probably be the smallest group—maybe 15% of the fund. But that depends on the market. For example, back in 1999 when the price-earnings ratios of Internet stocks and everything else were so high, we found less attractive valuation stories, so we were buying more company turnarounds. As the market has come down in the last 12 to 18 months, we've had a lot more in the valuation category compared to the turnaround category.

When you're looking at valuations, how do you value a stock and what do you consider to be an attractive price?

We look at several different valuation items, and we'll try to determine the intrinsic value of the company—what the whole company is worth. We'll look at the historical valuation range—how the company has traded both on an absolute and a relative basis, although we put more emphasis on absolute. We'll look at how the stock trades relative to its peers or competitors. Of course, it depends on the industry and the company as to which tools you use. A price-to-book ratio might work for certain financial companies, but it's certainly not going to work for a technology company.

What percent discount are you looking for?

Normally if we find a stock attractively valued, it should move up at least 50% over the next two to three years. What we are looking for is reversion to the mean—for instance, a stock that normally traded at 20 times earnings for the last 10 years, happens to be trading at 11 times earnings today because earnings are depressed or something has gone wrong. We'll play it from 11 to maybe 16 or 17 times earnings. We try to buy them at the low end and sell them toward the high end.

What we basically do is set a price target for 12 to 24 months out from the date of purchase. Assuming that price target is hit in that time frame, we will reevaluate the assumptions we made at the time we set the price target. If for some reason the assumptions need to be adjusted upward—for instance, we thought they'd gain 30% market share in an area and they're gaining 40% or 50% because their widget's even better than we thought—we would adjust the price target. But generally, we set a price target based on a stock returning to its normal valuation level and when it gets there, we'll sell and move on.

How do you compare the relative merits of the three different categories of value stocks that you look for?

We write up a report card on all the mid-cap stocks that we follow, and we grade them, A through F, on six items. Obviously, being a value fund, the number one item is valuation. The other items are: management, cash flow, balance sheet, Wall Street expectations, and industry position.

Valuations we already touched on. Management is a subjective grade, but we do find it very important to try to determine if management's compensation plans and their goals are in line with those of the shareholders. We'll also evaluate management's 10-year track record, industry knowledge, and expertise.

Number three is cash flow and four is balance sheet—they kind of go together. We want to own companies that are generating free cash flow, so we will examine the income statement and balance sheet. We talk to management about its use of cash both historically and going forward, as well as what the earnings and non-cash charges are going to be. We'll look for trends in cash flow, making sure those trends are moving in the right direction. We look at capital expenditures and, again, trends are very important.

In terms of debt, we don't require companies to have no debt, but the amount does depend on the industry, the consistency of earnings, and how much debt we are comfortable with.

The fifth item is a little different than the other items—Wall Street expectations. We use that as a gauge for the amount of optimism or pessimism regarding a stock. We always purchase stocks that have a ratio of buy versus hold or buy versus sell of less than one. In other words, we don't want to be buying something where six or 10 Wall Street analysts are screaming 'buy it' and there's no one saying 'hold it' or 'sell it.' So, we are looking for pessimism, which lowers the hurdle. If the company does anything right, the stock generally goes up, but if they do something wrong, well, that's what they have been doing—expectations are low, so most likely the stock is not going to go down.

The last item is industry position. There, we try to see if the company has any special market position—are there barriers to entry, are there substitute products for their service?

Just as an example of our report card system, take H&R Block, which we still own. There is no other franchise in the tax preparation or financial service area in this country other than H&R Block—nothing close to it. That is a very strong industry position. So when we found H&R Block, we gave it an A in industry position. Wall Street didn't like it because they were missing their earnings, so it got an A there. It had a strong balance sheet, they generate free cash flow—good marks there. Management at the time was changing, which we thought was positive, but we weren't sure about the new people—not necessarily a high grade there. But the valuation was very attractive based on its historical trading range. So we had high grades in five out of six items, and we were pretty confident in it. So we bought it, and it has done well. Right now, the valuation is not what it used to be, management's fine, cash flow is still there, balance sheet is still there, Wall Street is getting more excited about it, and the industry position is still strong. So the report card has weakened somewhat as we're getting closer to our price target. That's the kind of

mental gymnastics we go through when we evaluate a company.

What would prompt you to sell a stock?

Generally, two things. When we purchase a stock we will set a price target that we hope to attain in 12 to 24 months. If that price target is attained and the assumptions that were made to generate the target have not changed, we sell it.

The other sell decision, the painful one, is the mistake. Not everything reverts to its normal valuation level. There are times when we purchase what we call "value traps"—they looked cheap based on historical measures, we expect them to improve, but sometimes they just don't. When we've determined that the fundamentals are not going to accomplish what we expected, we'll sell the stock. Not everything that was going well and stumbles gets back up and starts running again. The PC industry might be an example right now. Not that long ago, Compaq, Dell and Gateway were big, multiple-growth computer companies, and now what are they? They're selling commodities and maybe people simply aren't going to be buying computers the way they used to—it could be a value trap, or it could be a value opportunity.

Was it difficult to stick with your discipline when the growth stock valuations were so out of line?

Extremely, but we did it. We simply could not make sense of the valuations. To some extent you'd go home at the end of the day or week and say, well, I can't go near those, I'm not going to buy them. I'll go drive a truck or something before we buy those.

On the other hand, we were still able to find value stocks in 1998 and 1999 because no one cared about them. Basically, we've stuck to our discipline, and we've happened to own the right value stocks—we have a methodology to our madness and we continue to improve it, and I think it shows in our numbers.

How do you see the market right now?

Being in a recession and having the uncertainty of the terrorist attacks of September 11, I think you need to draw a line on that date and look at things a little bit differently. Growth had its huge run, and then it gave a lot of it back. Value has had a pretty good run, but certainly not as big as growth. Now it's kind of settling in, so I think investors aren't quite sure if they want to be in growth or in value.

More importantly, people don't know what is growth and what is value today. All the tech stocks used to be growing and now they're not, so does that mean they're value? We won't know until a year from now because then we'll label them. But I think right now the market is extremely mixed.

I'm fortunate in that the discipline we use doesn't require me to figure out world events and world markets. All I need to do is find 50 stocks that are good companies that are temporarily going through some kind of problem, and invest in those. And I still think value has a ways to go.

Are you investing in many stocks that were formerly considered growth stocks—do you view them as value stocks now?

Some have definitely come into the value camp. Based on our report card gradings, I can find tech stocks that are well-managed, that have cash flow, that have strong balance sheets, that Wall Street hates now, that have good industry position, and the value has come down.

In my fund, I don't get to choose the sectors I'm going to invest in. Value has to come to me. When I read the Wall Street Journal everyday, I look at the 52-week low list. A lot of times, those stocks were on the 52-week high list a year ago. I scour that list, and tools like that, and if it's all tech stocks, that's going to be what I'm looking at.

In terms of your overall faith in the market, was it shaken at all by the recent events, or are you basically still a long-term investor?

Strongly long term. In one sense, having the terrorist attacks may be officially throwing us into a recession, and in a perverse way, it may make it easier. In the six months leading up to the attack, no one knew if we were really in a recession. Now we *know* we're in a recession. I find it, from a mental gymnastics perspective right now, a little bit easier.

When you're in a recession you might think a little differently. You might not worry about next quarter's earnings because we know they're going to be bad—they're supposed to be bad in a recession. What we're going to look forward to is the next year out, or 18 months out.

In the history of the market going back to the early 1900s, including the '20s and '30s, there's always been positives and there's always been negatives. But in the long run, if you're a long-term investor, it has always paid to be in the market. ✥