STICKING WITH SMALL-CAP VALUE IN A LARGE-CAP GROWTH BULL MARKET

FUND FACTS

HEARTLAND VALUE (HRTVX)

CATEGORY:
Aggressive Growth

PERFORMANCE: (thru 9/30/99)

Compound Annual Return (%)	Fund	Category
1 Year	8.1	39.5
3 Years	6.2	14.1
5 Years	11.6	17.8

RISK: (relative to category)
Low

TOTAL ASSETS: (as of 12/1/99)
$1.05 billion

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The markets have been tough on value investors and small-cap stocks in recent years, and the small-cap value approach has taken a double-whammy.

Some small-cap fund managers have reacted to the markets by altering their style, drifting more toward larger-capitalization stocks, and adopting a more growth-oriented approach.

At the same time, true value players are having a field day, finding bargains in many market segments that are being ignored by investors narrowly focused on high-priced Internet stocks.

One of the better-performing, true small-cap value funds is Heartland Value. Although it has seen its performance lag behind other aggressive growth funds that are more growth- and larger-cap-oriented, the fund has doggedly stuck to its style, following a true value approach in searching for stocks that are clearly small cap ["micro-cap" in today's terminology]. The fund currently has a little over $1 billion in total assets.

In early December, portfolio manager William J. Nasgovitz discussed his investment approach with Maria Crawford Scott.

What is the investment philosophy of the fund?

What we're trying to do is to capture the terrific upside potential of small stocks, while limiting the downside risk. So, we look for undervalued small companies—companies whose price does not reflect what we believe to be its potential value, either because it is underfollowed by analysts, misunderstood by investors, temporarily out-of-favor because of an overreaction to unexpected news, or perhaps simply an undiscovered emerging opportunity.

Basically, we have a low price-earnings ratio, low price-to-cash-flow ratio and low price-to-book-value ratio style. Essentially, we're trying to buy a good or even a great business at a very compelling price. We love half-off sales, and there are plenty of those going on in the small-cap market today.

What do you define as small?

Well, our prospectus says that 65% of the fund has to be invested in companies with market capitalizations [number of shares outstanding times share price] of less than $750 million, which is a relatively standard definition of small caps in the mutual fund industry. But of course there is a continuing debate as to what constitutes small cap. The traditional definition is the bottom 20% of New York Stock Exchange stocks, and that market cap last year was around $100 million. In the Value Fund, we want to focus on that particular small-cap sector, so half of our stocks [the median] are under $100 million in market capitalization. The other half are somewhat larger—we've got one or two that have grown to be over $750 million and we haven't sold them yet. We don't typically sell just because a stock has appreciated or grown out of our market-cap range. Our average market cap is $400 million.

How do you find the stocks?

Well, a variety of ways. We do use screens. But there are well over 10,000 publicly traded companies in this sector, and some won't pop up on a screen because either they're too small or they don't trade enough, so we do look at other avenues. For example, we monitor insider transactions. There's a small titanium producer called RTI International Metals that we've been looking at recently—principally because there's been strong insider buying. Also, an announced buyback or a strong actual repurchase of shares always interests us,

especially if the company is doing it with their free cash flow and not adding debt. Another avenue we follow comes from research suppliers, primarily a number of regional brokerage firms that we've built up a relationship with. And on top of that, we have our own research team of traders, analysts and portfolio managers.

Once you spot a company, then you apply your value criteria?

Yes. We have a 10-point checklist.

We want low price-earnings multiples, which means less downside risk if the market drops, but provides the opportunity for a sharp price increase if it is "discovered" by Wall Street.

We look for high cash flow, which permits a company to finance expansion internally, repurchase shares or increase its dividends.

We like to see companies with improving earnings.

We want a stock that is selling at a discount to book value (assets less liabilities), so we are buying at below what the company would theoretically sell for if it were liquidated.

We want to see a catalyst, such as a new product or something that will ignite the market's interest in the firm and cause the price to move up to what we feel to be its real value.

We want to see debt relative to total capital of no more than 25%, which indicates that the company is financially sound.

We like companies that have a high amount of insider ownership, so that management's interests are aligned with the shareholders.

We pay a lot of attention to the top management team—we want them to have a realistic vision for the company as well as a history of success.

We look for undervalued assets, such as understated natural resources, over-funded pension plans or fixed assets that are worth more than their stated book value.

And, in terms of technical analysis, we like to see stocks whose prices have formed long-term bases with positive upward movement.

What do you use to judge price-earnings ratios? Are you looking for low ratios relative to the Standard & Poor's 500 or the Russell 2000?

Actually, we think more in terms of the inverse of the price-earnings ratio, which is the earnings yield—earnings over price. This is a basic Benjamin Graham tenet—you pay $10 for a stock and if it's an Internet company today and they're not making any money, you have a zero return on your money. However, if the company is earning $1 per share, that's 10% on your money. We like to find stocks whose earnings yields are better than you can get from corporate bonds, which today easily pay 7%. To have any kind of a margin of safety, we need an 8% earnings yield, which is a price-earnings ratio of 12.5.

Growth stocks have far outperformed value stocks in recent years. Has that caused you to change any of your criteria?

It's been a narrow market, very focused on technology and the Internet. The Russell 2000 is up about 11% for the year, but the top 50 stocks account for roughly 90% of this year's gain. And those stocks range from $3 billion to over $20 billion in market cap—a lot larger than our target market.

The Russell 2000 growth index is actually up 29% this year, while the Russell 2000 value index is down 6%—a differential of 3500 basis points. I've never seen this before. The Heartland Value Fund is up just short of 8%, so we're beating the value index, but we're still trailing the Russell 2000, generally due to the skewing by technology and Internet favorites. These companies on average are selling at about 10 times sales, and half of them don't have any earnings. In fact, the way to have made money in 1999 was to buy companies with *no* earnings—if you would have bought only the Russell 2000 stocks with no earnings, you'd be up 45%.

So, it hasn't been a value market this year, but we are still very much value investors. Valuation is important to us—the fund is trading at about 13 times next year's earnings, which is about half of the S&P 500 multiple. It has a low price-to-book-value of 1.8, 26% debt-to-total capital, and eight times trailing cash flow. The S&P 500 is trading at around 19 times cash flow, just as an example.

What we've done this year is to put more emphasis on catalysts—it's now number one on our 10-point grid. The point is, how do low P/E stocks get recognized in this technology-Internet mania? And it really is a mania.

For example, we have a big position in a company called Henry Shein, a distributor of medical and dental products. It also has a very active Web site, much better in comparison to their competition.

Here's the unique thing: Today you can find leaders in the industry, but they are valued as small caps. This is a $2.2 billion company that got down to $400 million in market value. And they are the leader in a $200 million Internet business that is growing at 50% a year, but which the market doesn't care about. That's one of the catalysts with Henry Shein. The stock is down, by the way, from $40 to $11 because they disappointed analysts. We think they're going to earn $1.60 next year, and maybe their growth has slowed down a little, say to only $1.50, but at $11 or $12 a share, we're still talking about eight times earnings for an industry leader, for an industry that's growing faster than the economy, and for a company that's involved in the Internet.

Your approach has not kept you totally out of technology, then?

We are able to find value in some technology stocks—we have about 16% of the fund in technology. For

example, we own Sybase, which has a market cap today of $1.4 billion. It's a stock that's now trading at $17, but we paid $7. This is a fallen angel. At one time this company was trading at well over 50 times earnings and, if I'm not mistaken, over $40 a share. It fell into some rough times—they were up against some tough competition with Oracle, they missed a couple quarters, and the stock plummeted 80% from its high. We bought a million shares at $7, on an earnings estimate of 70 cents. This was a company with no debt, it had some cash on the balance sheet, and was in some very hot areas. And we were able to buy the business at 11 times earnings when it was out of favor.

There's another data storage company called Ciprico—we paid $9 for this company, essentially book value. They have no debt, and in fact they had over $7 a share in cash. They were profitable but they had an earnings shortfall. Now, a value investor will put more emphasis on the balance sheet rather than growth , and Ciprico is a good example. It was a good little growth company that stumbled, the stock dropped from $20 and got down as low as $7. Now their earnings are coming back. The stock today is $12, so we're up 33%. But if they put a couple of quarters together, and then a couple years together, all of a sudden the growth investors will flock back.

A lot of small tech has been out of favor, in some cases for good reason because the company had a bad year or had an earnings shortfall. That puts the price way out of whack in terms of earnings per share, so the stock underperforms, gets whacked and enters the value arena.

Is there any group that is undervalued right now but that you don't see a catalyst for and you are avoiding?

We have a number of mundane steel producers, and we aren't adding to those positions. In fact, we think one of them is a mistake, and we're taking a loss. For instance, we own Kentucky Electric Steel. We paid $7 for the company, the book value is around $9 and the stock today is trading for $2. But we've decided to move on and sell the stock even though it's below book value. Some of the more mundane businesses, I guess you could call them old economy stocks, we've just given up on, because we feel it's a management issue.

Certainly, the retail sector, which is being challenged by Internet retailing—we're not doing anything there.

Do you have much of a cash position?

No, we put all of our cash to work last year. We were in a high cash position during most of 1997—we had between $400 and $500 million in cash and we said we'd open up the Value Fund in a bear market [the fund was closed to new investors prior to that], and we opened it up in November of 1998. When the Russell 2000 dropped from 500 to 300 in that big sell-off, we bought about two dozen new names in the fourth quarter of 1998, and we've been really fully invested since then.

What would cause you to sell a stock?

We reevaluate all of the companies we own based on that 10-point checklist. For instance, we like low debt, and if one of the companies we own went out and bought another company and took their debt way up relative to total capital, we might sell the stock. Or, let's say the catalyst disappears—maybe they announced a buyback, but they really don't buy back stock.

What about on the up side?

As a general rule, if a stock hits a market multiple we start selling. Of course, then you get into the question as to which market multiple to use. The S&P is trading at roughly 30 times earnings, while the Russell is trading at something closer to 25 times earnings. Once a stock moves into the growth camp and gets a good multiple then we might do a little paring back, selling into strength and reducing our position.

Has this been a frustrating market for you?

It's frustrating in that it's the best of worlds and the worst of worlds for a small-cap value investor. It's the best of all worlds because of the great values we are able to find right now among small caps. But it's the worst of worlds because if you are true small cap and true value, you are in a very small minority today. To outperform the Russell 2000, you had to be in the bigger-cap stocks, and to move there would, to us, be style drift. So that's frustrating.

The other frustrating part has been that you buy a great company, you pick a great stock, the management does everything that you hoped they would do, you built up a big share position and the stock doesn't move. The market always goes to extremes, but that's really part of the game, right? On the up side and on the down side.

I think there's going to be a tremendous washout in hundreds and hundreds of overpriced securities, large and small. And value funds will probably get hurt a little bit too, but not nearly as much, because they've already gone through a bear market. We think the risk/reward ratio is much more favorable in some of these beaten down, good little companies that are growing at more than 15% a year but are trading for cash per share or trading below book value or are trading at 10 or 11 times earnings. They're low-expectation stocks.

In addition, the supply of small-cap value shares is actually going down because there are so many share repurchases going on—there's a scarcity value to all this.

So, that's where I believe the place to be is—the not-so-nifty fifty. ◆