A PASSIVELY ACTIVE COMBO USING A FUNDAMENTAL VALUE APPROACH

FUND FACTS

AMERISTOCK MUTUAL FUND (AMSTX)

CATEGORY:
Growth & Income

PERFORMANCE: (thru 9/30/00)

Compound Annual Return (%)	Fund	Category
1 Year	13.7	15.3
3 Years	17.6	10.7
5 Years	23.2	15.9

RISK:
Below Average

TOTAL ASSETS: (as of 12/1/00)
$126 million

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Very few investment strategies are capable of beating the market over the long term. Certain strategies tend to do well over particular time periods, but then falter when market conditions change.

One technique, however, that is guaranteed to add to any strategy's bottom line is to keep expenses and trading costs low. That's the strategy behind index fund investing.

It is also a main focus of one fund that has done particularly well over the long term—the Ameristock Mutual Fund, a large-cap growth-and-income fund. The fund has managed to outperform the S&P 500 over the last year (13.7% versus 13.2% for the S&P 500), the last three years (17.6% vs. 16.4% for the S&P 500), and the last five years (23.2% vs. 21.6% for the S&P 500). (Note that the fund currently is not listed in the Low-Load Mutual Fund Guide; performance figures are, however, available from the "fund quotes" section of the AAII Web site.)

Currently, the fund has about $126 million in total assets. In early December, portfolio manager Nicholas D. Gerber discussed the fund's investment strategy with Maria Crawford Scott.

What's the basic investment philosophy of the fund?

Ameristock mutual fund is a no-load, domestic, diversified fund that invests in large companies. By large, we mean companies with a market capitalization (number of shares outstanding times share price) of $15 billion and above—the bluest of the blue chips, as we like to say. If there is ever a company in the portfolio that you don't immediately recognize, it probably means we are drifting from our style.

In terms of investment style, we use a combination of active and passive portfolio management. In 1995, when we started the fund, we owned most of the companies in that universe—there were 65 companies at $15 billion and above. These days, there are about 200, so we don't own nearly as many as a percentage of our universe, but we own practically every industry.

As a result, we are very well-diversified. But the weighting that we give each of our holdings is based on value, and to determine that we use traditional fundamental analysis.

Once we have the different companies in the portfolio weighted according to value, we turn around and act like an index fund. Of course, we're not an index fund—we don't weight the companies according to size, but rather we do it according to value. But we do have very low turnover; we have a very low total expense ratio; we are very highly tax-efficient. When we do sell, we use specific-lot tax accounting. We're trying really to combine the best of both possible worlds.

How do you weight the companies based on value?

We break it up into three big buckets. Companies we own that we think are undervalued, we put at 4%. Companies we own that we think are fairly valued, we put at 2%. The third bucket consists of companies we want to own because they dominate their industry, have great brand names, have been around forever, and are going to be around forever—like Disney—or companies where we truly believe the people running them are a lot smarter than us, and we don't mind going along for the ride—like Microsoft. However, these companies are not cheap, so we have them at 0.5%.

Basically, then, you are protected in all market environments—for instance, when value stocks do well, the value portion of your portfolio will perform well, and when growth stocks do well, the portfolio has at least some exposure to growth.

Yes, we do own some traditional growth companies like Microsoft and Intel. Recently, we added Dell Computer—people think of it as a growth company, but considering that the stock has come down so far, we think it has value.

Do you ever invest more than 0.5% in growth stocks—in other words, have traditional growth stocks ever, in your opinion, become undervalued or at least fairly valued?

Without a doubt. In fact we think a lot of technology stocks these days are fairly valued, and that's why we added Dell. The only companies we've added in over a year were Dell Computer and Albertson's, and Dell Computer is actually the first technology company we've ever added to our original universe. That's not to say we haven't added to our position in Microsoft or Intel, both of which we've been doing a lot of lately. So yes, just because something has the "growth" label attached to it, doesn't mean that it's not of value at certain points in the cycle, and it's during those points that we tend to be the buyers.

Did Dell reach some sort of market-cap limit that caused them to be added to the fund?

Their price-earnings relative to their growth rate and their price-to-sales growth rate are the lowest they have ever been, and combining that with their return on equity minus the cash that they also have, we thought that it was the cheapest that they're ever going to be. Dow Chemical, Caterpillar, Albertson's—which are all in our 4% bucket—are cheaper on an absolute fundamental basis. But unless something truly horrendous occurs, Dell Computer will never be that cheap. So, yes, I guess we paid up for growth, but we do think there's value there right now.

Are most of your stocks in the S&P 500?

There's a high overlap there, yes. But we own 48 companies, and the S&P 500 is 500 companies.

What about large-capitalization companies that are not in your portfolio?

There are some S&P 500 companies that are not in our portfolio because five years ago they were not $15 billion and above, and they're still not considered cheap, like Cisco. It's a great company, but it wasn't that big when we started, so it wasn't even something we considered. Now it's big enough, but it's not cheap—even though it has come down 25%, it's still not cheap enough for us.

Then there are other companies, like Amazon.com, which didn't even exist five years ago. They're big enough now, but we don't think they really should be above $15 billion.

What kinds of fundamental evaluations do you use to determine the company weightings?

We'll look at the company's sales—is it increasing over time? What about income, is it increasing over time?

We also look for very free cash flow, which we define as dividends—that's cash flow so free the company can't even use it, and it is given back to investors because they can put it to better use. In the kinds of companies we invest in, they are as big as they're going to get within their industry, and yet they are producing excess cash flow. If they were to put the cash back into their own industry it would be a waste—for instance, if they try and diversify and get into other industries they may not do such a good job. But if they give it to back to investors, then they may turn around and pick the next Cisco. So, we like companies that pay dividends.

We also like low price-earnings ratios, low price-to-sales ratios, and all the other good value-type ratios.

Dividend yields are extremely low right now. Is that bothersome, since you like companies that pay dividends?

Dividend yields are low right now, although our dividend yield is actually about a third higher than the market in general and has been since the beginning. It would be nice if more companies paid higher dividends, but we adjust.

But dividends aren't necessarily tax-efficient.

No, they're not, but they give a cushion during bear markets, and they're sometimes the best way to give money back to the shareholder. Not every company should invest in itself, invest in its industry, or knows how to diversify.

Do all of your valuation measures have to be there for a stock to be considered undervalued?

They don't always agree. Different companies have different capital structures, and they use their available cash flows in different ways. Some pay out high dividends; some use it to reinvest in the business, and they can continue to grow that business by reinvesting the cash. So, a company may have a very low dividend yield, and yet a very high return on equity. They don't always have to agree, but they all have to point in the same direction.

What other criteria would you take a look at, other than valuations? For instance, do you prefer leading industries?

No, it's purely bottom-up. We don't look at industries. If we have over- or underweighted an industry, it is because when you're looking at individual companies, the same macroeconomics that are affecting one company are also affecting other companies in the same industry. For example, the last time we added companies to the portfolio was a year and a half ago when we added Allstate, Washington Mutual, and PNC Financial Services. We came to each one of those on its own, and it just so happened that they were all financial services firms. At that time, everybody thought interest rates were going to go up, which they did; everybody thought financial services consolidation was over, which it wasn't; and everybody thought that technology would go to the moon, which it did—then it came back.

Do you try to maintain industry diversification?

We do try to be well represented. The most we ever put in one industry was this summer, with 40% in financial services, which includes insurance, banking, and brokerage. However, that made us feel very uncomfortable, and we're back in the 20% range now. We do that by putting new money toward other places. That's how we can be tax-efficient—we don't have to necessarily sell Washington Mutual or PNC, but as new money comes in, we just don't buy more of them.

Why would you sell a stock?

There are four reasons to get out of a stock. One is that it's no longer in the universe, and that's not just because, say, Sears went from $15 billion to $10 billion, but rather a PepsiCo spun off a Tri-Con Global Restaurant. If it's no longer in our universe, or we don't know if it's about to be in our universe, we'll sell. That's one reason.

The second reason is if investors want their money. If we don't have enough cash in the fund and we have redemptions, we have to sell.

The third reason would be if the fundamentals of the business change—in other words, a company is no longer what it was historically, either it's no longer going to be a blue chip, or something in the future is different than what it was in the past.

We've only had two companies that have done that: Eastman Kodak and Philip Morris. The easy one was Eastman Kodak. We sold that a few years ago when we saw that cameras were going digital. We thought that Eastman Kodak would have great market presence in the new digital camera world, but we felt that it was not going to be 80%, which is their market share in film. It will be maybe 30% or 40% of the digital world. And any company that's going from 80% of a market to 40% of a market is a big enough business risk change that we did not want to be a part of it. Hopefully we're wrong. But when we sold it, we felt it was going to take five to 10 years for any conclusion to be drawn, and we're still in that inconclusive time period.

The fourth reason we would sell is if a company becomes too expensive. But here we're very, very lenient because we do have that 0.5% bucket, and we do like to do things slowly. We're one of the few funds that tries to put time on the investor's side. We're not buying and selling frantically. If we do nothing, that's a good position, too.

What do you mean by "lenient"?

When we say we're very lenient, we usually mean three-and-a-half times whatever the market multiple price-earnings ratio is; these days, our level would be about 100. And the only time we ever really sold anything on that basis was Lucent Technologies, which we sold in October of 1998 when it reached a price-earnings ratio of 110.

How do you tax-manage the portfolio?

A lot of funds either simply sell the first lot that they bought or the last lot that they bought, and they use the average cost basis to determine gains and losses. First of all, we don't like to sell—if we're going to reweight the portfolio, we'd rather use the existing cash flows that are coming into or out of the fund. And then when we actually do want to sell, we use specific-lot tax accounting: We get a full run of all of the buys that we made for any particular company that we are selling, and we match up long-term gains with long-term losses, and short-term gains with short-term losses. That's sometimes a long process after you've done a quick buy or sell—you may sit there for a half hour or 45 minutes trying to figure out which lots to apply it to.

A good reason not to trade too frequently.

Yes. It just makes our work more complicated and makes the IRS happy—two reasons not to do it.

Your performance has been very good over the long term. What do you attribute most of your performance to, your individual stock picks or the overall buy-and-hold strategy?

The strategy will hopefully put us in the top third of all funds in our category over time because we save money by not trading, we save money by not paying taxes, by not having slippage, and we save money by having a low total expense ratio. The other funds tend to trade and have high expenses, so if we have the same returns as they do, we win.

In terms of shorter-term performance, I would attribute it this year to our commitment to financial services, which is the same reason we underperformed last year. We owned a lot of financial services last year, not a lot of technology: technology did great, financial services didn't. This year it was the mirror image. ✦