VALUE APPROACH SEEKS SMALL-CAP FIRMS THAT ARE UNDERGOING POSITIVE CHANGES

FUND FACTS

CRM SMALL CAP VALUE (CRMSX)

CATEGORY:
Growth

PERFORMANCE: (thru 9/30/01)

	Fund	Category
Compound Annual Return (%)		
1 year	8.3	(17.8)
3 years	12.6	6.0
5 years	9.7	8.8

RISK:
Below Average

TOTAL ASSETS: (as of 12/1/01)
$300 million

CONTACT:
CRM Funds
800/276-2883
www.crmfunds.com

While the markets have rebounded from the lows reached after the tragic events of last September, the performance of most stock mutual fund categories in 2001 was grim indeed. Yet there were a few pockets of positive performance—the small-cap value category, in particular, managed to bounce back in the fourth quarter and finish the year with handsome returns.

One small-cap value fund that has performed well over the last few years is CRM Small Cap Value. The fund was among the top 25% in the growth fund category over the last year and last three years, through September 30, 2001; through December 17 the fund's year-to-date return was an impressive 22.4%.

Currently, the fund has roughly $300 million in total assets.

In early December, portfolio manager Scott L. Scher discussed the fund's investment approach with Maria Crawford Scott.

What is the investment philosophy of the fund?

We have a value philosophy—we want to buy a company at a discount to what we perceive its private market value to be.

Our approach is that we try to find stocks that satisfy several criteria. First, we want them to be cheap on some basis, and usually we measure that in terms of price relative to private market value or cash flow.

Second, we want them to be neglected—usually with very little Wall Street coverage, or there may be Wall Street coverage but the expectations are fairly low. If there are five Wall Street analysts, hopefully three or four have holds and maybe one or two have buys.

Third is that we want to find situations where we can do due diligence on the company—where we can do an extensive amount of work and really understand the business. We tend to know our companies as well as, if not better than, other investors, and we tend to spend a lot of time getting to know what we own.

Lastly, one of the very important things is that we like to have a catalyst in place when we buy a stock—something that we've identified, either today, or in the next six to nine months, that's going to unlock value in the company, that will make the company look different tomorrow than it does today. Those catalysts most frequently tend to be a change in management, or a change in the asset mix of the company—in other words, a divestiture or acquisition. If we think a company is going to look different than it does today, we think we can gain insight into what it's going to look like and what the earnings power is going to be. And if we think that Wall Street's not paying attention, and that six to nine months from now they will pay attention, the stock will move significantly higher. We tend to do a lot of work on spinoffs—for instance, where a larger company spins off a smaller division. Those tend to be very inefficiently priced because other investors—particularly larger-cap fund managers—tend to sell those stocks indiscriminately. They really can't own them, since they are too small.

How do you find prospective companies?

Some investors use screens, for instance screening for companies with low price-earnings ratios. We screen on change. We are looking for management changes in mid-size companies. We are looking for companies that have four divisions, where one is losing money and another one is breaking even. In this situation, a traditional price-earnings ratio analysis would suggest the company is fairly valued. But obviously, if it's got four divisions, one's breaking even, one's losing money, in essence, you're not subscribing value to two of those businesses. In a break-up analysis you'd come up with a higher target price or a higher valuation because you'd look at peak-to-trough value and you would apply value to those other businesses.

Every stock analysis is unique and the way we go about ultimately buying each stock is unique. However, the consistency is the type of work that we do, which is to truly understand what the company does, who they compete against, what their market position is, is it a good business or not a good business, are the problems today fixable or are they not fixable? We do a tremendous amount of work on the underlying business.

The fund focuses on small caps—what is your definition of small cap?

At the time of purchase, the bulk of our stocks will be below $1 billion, and we tend to go down to about $200 million. But given our asset size, anything smaller than $200 million really begins to make very little sense.

And, of course, stocks can become larger. We don't have an automatic sell discipline based on market capitalization. That being said, stocks that have become inordinately successful for us and appreciate beyond $3 billion in market cap, tend to get sold because they're no longer cheap and no longer meet our investment criteria.

We also tend to run very concentrated portfolios—there tends to be anywhere between 45 to 55 stocks in the portfolio, with a concentration in the top 10 of about 35% and anywhere between 60% to 70% in the top 20 names.

How do you decide how much of the portfolio to commit to each of the higher percentage stocks?

Our highest percentage stocks are those in which we think that the risk/return relationship is the most attractive. That's answer one. Answer two is liquidity at time of purchase and our ability to buy the stock at a reasonable price.

With a concentrated portfolio, do you pay attention to sector diversification?

In terms of our sector breakdown, we are bottom-up analysts and find our names on a stock-by-stock basis. That being said, we are sector aware and understand where we are overweighted and underweighted versus the Russell 2000 value index. We pay attention to that. We limit our sector exposure to no more than 30% or 35% in any one broadly defined sector and use that as a risk control mechanism.

Does the value approach cause you to be underweighted in certain areas—for instance, technology?

No, not necessarily. We've been overweighted in technology the last year and made a tremendous amount of money in it despite the Nasdaq being down 60%. One of our biggest stocks is Perot Systems, which is up 90% over one year, and it's a technology stock.

We do bottom-up analysis, and the Russell 2000 probably has 400 or 500 technology stocks. My guess is that in any year, in that 500, the disparity in returns is pretty wide. It's our job to find those stocks that meet our criteria, so irrespective of what the sector might be doing, it's our job to find individual names that make sense for us.

Our goal is to own the most exciting, fastest growing, best companies in America at very cheap prices when other people don't want to own them. It's not our goal to own the ugliest, worst or most badly managed companies in America and hope and pray that they're going to get better.

You mentioned Perot Systems—what attracted you to that stock, as an example of how your process works?

We found the company last fall in the November-December timeframe. We started looking at it when the stock was about $8 to $9, and we identified a couple of things. One was they had about $3 a share in cash, no debt and they were buying back a lot of stock. It was a very cheap stock in that regard.

The second thing was that they had a new CEO. Ross Perot Jr. had just been appointed CEO, taking over from his father. After having one or two conversations with him, it became pretty obvious that he had a very aggressive management style. Business was slowing from a top-line standpoint. Perot is an outsourcing company that competes with the likes of EDS, which was a Ross Perot–founded company. Their outsourcing business tends to have a very high recurring revenue stream. We like companies that have recurring revenue streams, companies who know what their business is going to be next year. And the company said that in 2001 they would probably earn 60 cents. So when you backed out the cash, you were paying about 10 to 12 times earnings when the company's peers were trading at 20-plus times. You were getting downside protection by the stock buyback. And on top of that, you had a new CEO who was cutting costs, which in effect was going to guarantee that you'd hit the earnings.

We thought we were buying this company incredibly inexpensively. There were three or four analysts who followed it, and all of them had holds—there were no buys on the stock. The reason the stock was cheap, down from $30 in the beginning of 2000 to $8 at the end of 2000, was that they disappointed on earnings. Business had been weak across the industry and, specifically, they had three large customers who were a very big portion of their business who each had down revenues in 2000—all for very explainable reasons.

We did our analysis, spoke to management, spoke to the competitors, EDS, Computer Sciences, met with management a couple of times, did some financial models, and concluded that we were buying the stock at an extremely inexpensive level. I guess we were right because the stock has gone from $10 to $19 this year despite the fact that the Nasdaq's down 60%.

What are the things that would prompt you to sell a stock?

On the upside, when it reaches fair value. We don't tend to own growth stocks so these are not stocks that we can own indefinitely. Once they're efficiently priced and they're no longer small, they don't fit our criteria.

On the downside, we sell stocks if we're wrong—if we got the analysis wrong and the fundamentals deteriorate, or if we think that the catalyst that we've identified actually is not going to unfold.

Our turnover tends to be about 70% to 80%. We tend to hold stocks, by definition, anywhere from 12 to 24 months—although we've owned some stocks for five years.

Does your investment approach change much during different market environments?

We always use a bottom-up value approach. But the stocks we will own will change in terms of what we're seeing on the economic horizon. We don't make top-down forecasts—we don't walk into the office in the morning and think we know what GDP or interest rates are going to do. That being said, sometimes we find stocks that are extremely cheap because people think the economy's going to be weak and we think the stock's overly discounting that. Everyone is implicitly making an economic call in the stock that they own and the biases they have with regard to the sectors. You can't get away from that. Although we say we don't make economic forecasts, if you're overweighted in consumer cyclicals or cyclicals, you are implicitly making a forecast.

You've had a phenomenal run for the past three years. In 1998, the fund didn't perform that well relative to others in the category. Was there a change in approach or was it simply a bad year—what accounted for the problems then?

If you remember 1998, it was a very volatile year—somewhat similar to this year actually. We really didn't respond to some of the things that were going on in the market. In 1998 we were a little overweighted in oil stocks, which hurt us. We didn't adjust the portfolio enough in the third and fourth quarter to catch the tech rebound in the fourth quarter of 1998. That being said, some of the positioning we were doing really helped us in 1999.

What is your outlook for the market and small-cap value stocks?

I think there are three answers to that.

From an asset class standpoint, obviously things are not as cheap as they were in March of 2000. On a relative basis, 1999 was a once-in-a-lifetime event of having growth do what it did and value do what it did. The probability of that happening is so far out on a statistical tail, it's just almost impossible to imagine that it would ever happen again. And now you've had two years in a row of small-cap value being the best-performing asset class. That being said, small-cap stocks relative to large caps are still extremely cheap. Have you looked at any industry or sector and ranked companies based on market cap? You would still see a major liquidity premium being applied to large-cap stocks. We still think small-cap stocks are cheap.

Second, small-cap stocks tend to outperform in the early recovery stages in an economic cycle. Why? The reason is that small-cap stocks tend to have more financial leverage, they tend to be more one-product focused, and they tend not to be international in scope. So these stocks tend to be more volatile, they tend to get hit more in economic downturns, but then do very, very well in a recovery phase.

Point three is that going forward, we think the market is going to be on a more level playing field—we think it will be a stockpickers' market, similar to the early 1970s when it was a wonderful time to be a stockpicker and a horrible time to be an indexer. Indexes did absolutely nothing back then—they were flat for a decade. We think that we're heading back into one of those environments where the averages might not do much, but individual stockpickers who are nimble, who know their companies, who understand how to value businesses, and do due diligence—we think those are the types of people who are going to do well. ✥