



ANDRESEN AND ASSOCIATES

P.O. Box 1434 Salinas, CA 93902
(831) 758-1575 or 1-800-345-9644

WWW.ANDRESENASSOC.COM



May 5, 2006

Magic Beans... Investing in Small Stocks in the New Century

So far in 2006, the stock markets have been turbulent and uncertain. The large stock S&P 500 Index is up 5.73%. The Pacific

Stock Exchange Tech Index, as measured by the North Track fund (PPTIX), is up 4.34%. Yet small stock funds are up much more than either of these. Our N/I Numeric Emerging Growth fund (NIMCX) is up 18.69% and our Royce Total Return fund (RYTRX) is up 10.41%. What's going on? Why are these funds doing this, and what should we expect in the future?

N/I Numeric Emerging Growth is a small stock mutual fund. This means that the management only invests in companies that are relatively tiny in size. Such companies tend to be under-analyzed. Anyone who wants to find a bargain in the stock market is more likely to find it in smaller stocks. For this reason, small stock index funds such as the Vanguard Small Cap Value Index tend to perform less well than successfully managed funds which invest in the same stocks.

However, studying this index fund versus N/I Numeric Emerging Growth reveals that small stocks in general have done very well recently. Since June, 1998, the large-stock S&P 500 has produced a 34% return, and the Vanguard Small Cap Value Index has provided 119%. A great deal of N/I Numeric Emerging Growth's performance can be explained by our choice to diversify in a small stock mutual fund rather than standard large cap fare.

But over the same time period, N/I Numeric Emerging Growth produced 200% versus 119% for the comparable index. So the fund management itself has produced substantial gains which can best be explained by good stock selection. How do they do it?

N/I Numeric Emerging Growth uses a proprietary computerized system for stock selection. I have no idea if this adds value or not. I DO know they are doing something else right: this fund is closed. When a mutual fund is "closed" it means that the management is not accepting new clients. This keeps the money under management from growing.

When a mutual fund does well, it usually gets flooded with money by people seeking the latest hot investment. Large stock funds usually don't have a problem with this since the stocks they buy are very liquid and easily traded without moving the stock price much. So these large cap funds can bloat up to the size of most nations' entire net worth, into the billions of dollars.

The situation is very different for the managers of a small stock mutual fund. The stocks they seek are thinly traded. There are not many shares of any given small stock out there. As a result, when the fund grows, it becomes harder and harder to allocate a decent percentage of the portfolio to any single stock. Good stock picks become diluted by the need to have many stocks in the portfolio just to keep the money reasonably invested.

Small stock funds which are flooded with money may morph into a portfolio of larger stocks, just as the Brandywine Fund (BRWIX) has done. Another solution is to hold hundreds of different small stocks. When an overly-large small stock mutual fund tries to reduce its holdings, it can easily drive the price of a thinly traded stock down, simply by dramatically increasing supply on the market.

N/I Numeric Emerging Growth closed when assets under management hit \$100 million, which is small for a mutual fund. Andresen & Associates is able to add money, but only because we are pre-existing shareholders. The fund now has an average stock size of \$610 million. Royce Total Return, another of our small stock fund selections, is still open to new investors. It has a portfolio size of almost \$6 billion, with an average stock size of \$1,636 million. As you can see, N/I Numeric Emerging Growth is able to invest in much smaller stocks because of its relatively small portfolio size.

Small stocks tend to thrive early in a stock market cycle because small companies can react to an improving economy more rapidly than larger corporations. That's why small stocks have thrived since the tech crash of 2000. Later in the theoretical economic cycle, small stocks lose ground to large stock mutual funds. This is because larger companies tend to do better in a mature economy, since they can apply the benefits of scale.

According to the rules, we should now be seeing large-cap stocks, and hence large-cap mutual funds, outperforming their smaller cousins. That has not happened yet. My guess is that fear has kept investors from perceiving our economy as fully mature. As a result of investor fixation on small stocks, many small stocks are actually priced at fairly expensive levels compared to larger holdings. This suggests that a transition to larger stock leadership is out there somewhere.

If you have been a client of Andresen & Associates, small stock mutual funds have been very good to you. But I'm not planning on adding much more. You want to keep your portfolio diversified even when one sector is doing very well, to protect against the unexpected.

And as for timing our way out of small stocks, brutal experience has taught me to listen to the markets rather than try to predict. Patience will serve us well. I don't plan to sell now. I expect to wait until the financial markets tell us that large caps are gaining, and then transition a portion of your small stock mutual fund money to proven performers in the large stock mutual fund arena. 🍷

Growth of \$10,000: from 06-01-1998 to 03-31-2006

Fund/Index	Total Return %	Annualized Return %	Amount at End of Period \$
Brandywine	80.07	8.60	19,007
N/I Numeric Inv Emerg Gr	199.94	15.05	29,994
Royce Total Return Inv	140.57	11.88	24,057
Vanguard SmCap V I Idx	119.46	10.55	21,946
Standard & Poor's 500	33.91	3.80	13,391

