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A CLOSER LOOK AT VALUE

Unless some radical change occurs in the stock markets, it appears that the S&P 500 and NASDAQ stock market indices are headed for an almost unprecedented third losing year. Meanwhile, valuations in these indices seem very high.

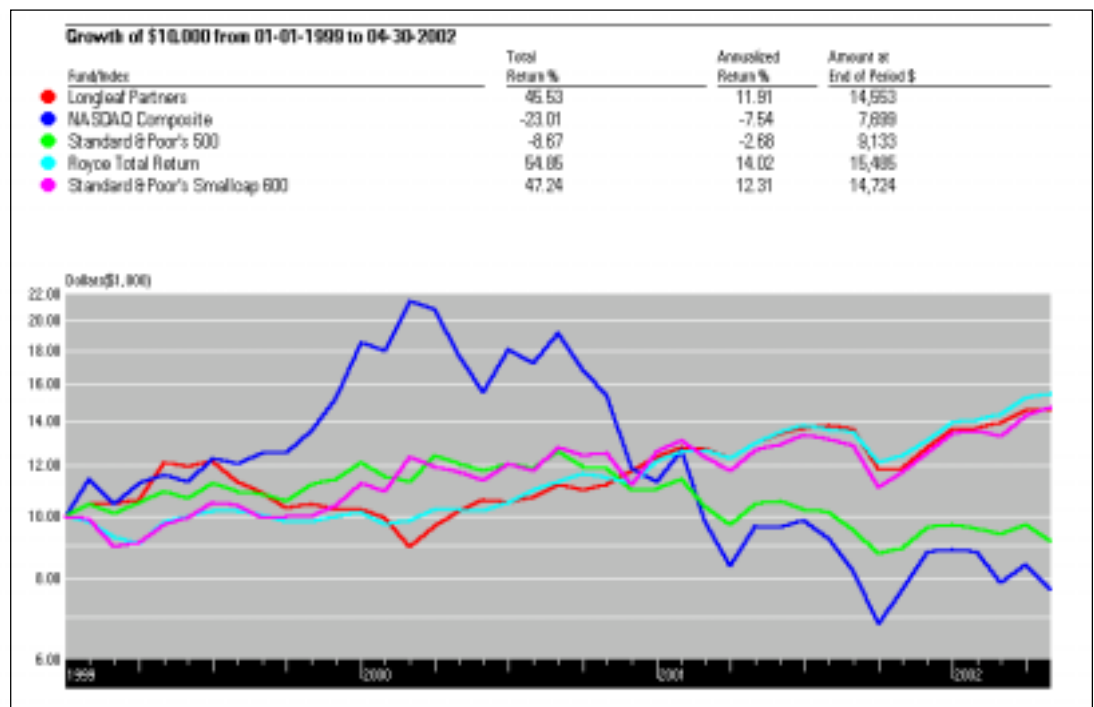
And yet...when you study your last quarterly report, or when you study year-to-date returns for mutual funds, you can't help but notice that many funds aren't having a losing year at all. In fact, many of the value funds in which we are invested are actually doing fine. For these funds, the 1990's bubble never existed.

As you can see in the graph below, the NASDAQ is down 23% during the past 3 1/2 years. It is down a total of 58% from January 1st, 2000. The more mainstream S&P 500 Index is down 24% from January 1st, 2000, and down 8.67% in the past 3 1/2 years. So far, this has been a tough millennium for growth stocks.

In the midst of all this carnage, value funds, which seek out stocks with lower p/e's, are actually up for the same period. Longleaf Partners, a mid-cap value fund, is actually UP a total of 45% during the past 3 1/2 years. Royce Total Return, a small value stock fund, is up a total of 54% as well. **These are good days for value stocks.** Investors are piling into these previously ignored stocks and appear likely to create a small value stock bubble.

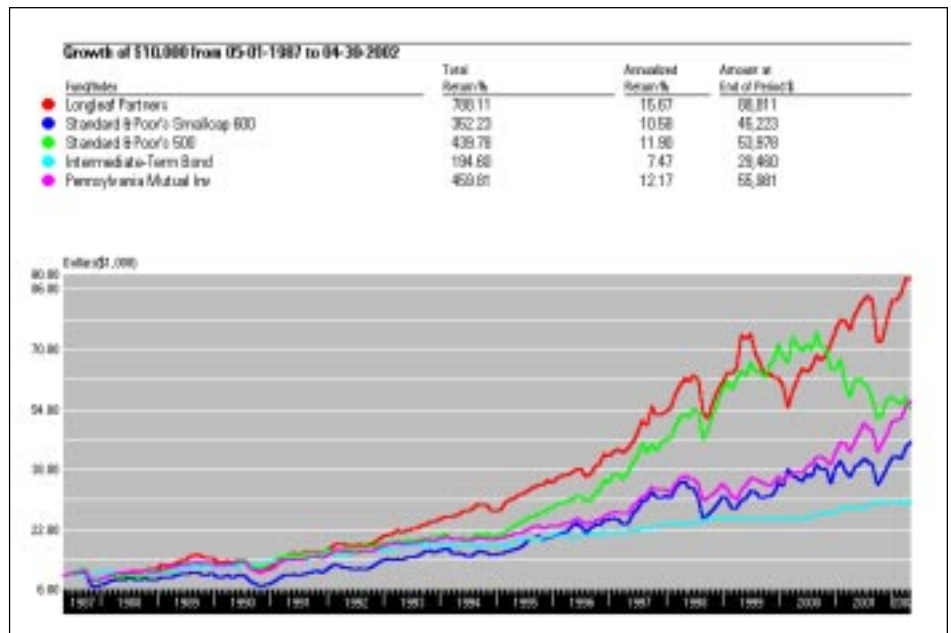
When you look deeper into why this is happening, it becomes apparent that the growth and value markets disconnected in 1998-1999. On the graph below, you can see the NASDAQ surging while the value funds stay flat or actually decline. Investors sold off their "old economy" value stocks to buy tech. As a result, value mutual funds such as Longleaf Partners suffered. This fund was up only 14.3% in 1998, while the S&P 500 grew 28.6%. In 1999 it grew a paltry 2.2% while the S&P 500 Index banged out a resounding 21.1%. Longleaf Partners and other similar value funds were roundly derided as being out of step. Many value fund managers were replaced. It seemed that growth would be king forever.

Now, using the perfect 20/20 hindsight with which we are all gifted, we find these value funds outperforming the S&P 500 Index in ten and even fifteen year performance records.



How did they do this? Are we now facing a new generation of gurus akin to the tech geniuses of the glory bubble days? A deeper study of value stock mutual funds is quite revealing.

It is a frustrating experience to search for a comparative index for small value stocks. For the purposes of this study, we don't want to use the Lipper Small Cap Value Index because it is made up of mutual funds. Yet any individual stock index must be arbitrary and selective by definition. After all, to create an index, someone must decide which are value stocks and which are not. The best index we could find is the S&P Small Cap 600/ Barra Value Index. As you can see in the graph to the right, this admittedly somewhat arbitrary collection of small stocks lagged the bigger stocks in 1999. Now it is producing gains similar to what we're seeing in actively managed value funds. It also has an average p/e of 24, about 80% that of the giant stocks of the S&P 500. What this means is that there is an entire class of undervalued stocks awaiting investment dollars. The performance of our value funds is not a lucky aberration: an entire sector is producing positive gains.



As you can see on the fifteen-year graph above, there appear to be two types of management taking place. The Longleaf/Dodge and Cox/Torrey model is to pick just a few very undervalued stocks and hold on for dear life. Eventually, the theory goes, the overall investing public will target these stocks. The superb long-term records of these funds indicate that this model works very well, albeit with increased volatility. Historically, long-term investing in these funds is rewarded, but an investor needs to be willing to hold on during the dry spells.

The alternative version of value management appears to include buying many different holdings and riding the overall value tide. Royce Total Return, for example, has 392 different stocks. Gabelli Asset Fund invests in 394 different holdings. We are witnessing a value version of momentum investing, a quasi-indexing technique which worked so well and later so badly for the Janus family of funds during the late, great tech bubble.

What this seems to indicate is that we are correct in approaching this value renaissance with flexibility in mind. Over-allocating to value funds may be appropriate now. I'm not seeing any real indication that growth investing is recovering. Later, however, we should be prepared to rebalance our portfolios. As you can see in the above graph, the Standard and Poor's Small Cap 600/ Barra Value Index has a history of laying low during stock market booms. We may wish to rebalance from these quasi-index funds back to growth funds once value seems to have run its course.

There's additional wisdom in our last graph. While small value stocks have lagged the larger stocks over the last fifteen years, they have outperformed precious metals stocks, natural resources stocks, real estate investment trusts, and intermediate bonds. They have done this with relatively little risk. Rather than bouncing from sector to sector trying to guess which venue will be hot next, history suggests that we will do better in these trend-riding small cap value mutual funds.

