

# THE WALL STREET TRANSCRIPT

Questioning Market Leaders For Long Term Investors

## Investing in Small Cap Value Stocks



BRUCE H. GELLER, CFA, joined Dalton, Greiner, Hartman, Maher & Co., LLC, in 1992 and is Chief Executive Officer and a shareholder. He is also a member of the firm's Management Committee. Previously, he worked as an Analyst in the Public Finance Department at Bear, Stearns & Co., Inc. He is a summa cum laude graduate of the State University of New York at Albany, where he received his BS in Business Administration in 1991.

**TWST: Would you start with an overview of Dalton, Greiner, Hartman, Maher & Co.? Tell us what you do there and about its investment philosophy.**

**Mr. Geller:** The firm has been around for 25 years now. We manage about \$1.4 billion with a value oriented, fundamental bottom-up philosophy. We tend to do very in-depth research on the companies that we invest in.

The basic tenets of our philosophy are to buy companies with above average quality characteristics, and what I mean by that would be companies with above average profitability, strong balance sheets and very strong free cash flow generation, and we buy them when they are trading at a discount to the overall market or to their peer group. We run six different products right now. We have an all-cap, mid-cap, small cap and micro-cap, as well as two long/short products. One is a traditional long/short hedge fund and the other is a 130/30, which we started running back in October 2007.

Really the way we view ourselves is as a research powerhouse in the value space with a smaller cap bias to what we do. And we have a product line that capitalizes on that research that is being generated by the firm's 11 sector specialists. We have 11 individuals on the investment team, all of whom are very experienced. Many of

us have worked together for quite a while at this point and each person is responsible for one or two specific sectors of the economy. They do all the stock picking, they are responsible for all the buy and sell and short decision-making within their sectors across the entire cap spectrum. We are very research-focused, bottom-up stock pickers, and the product line we have is an offshoot of this substantial body of research that is being generated on a daily basis.

All the products are run as a team. Each product has a team leader, but it is not a portfolio manager in the traditional sense, in that that individual is not picking all the stocks for the portfolio — it is more of an administrative role.

Going back to what I said about the sector specialists, it is the individuals who really populate the various products with all the decision-making within their particular sectors across the product line, and the team leader for each product oversees this process.

**TWST: Before we get into more detail on the process, Bruce, how is the investment climate for your small cap stock investment process, and what is the outlook going forward?**

**Mr. Geller:** We are coming off our best year ever in terms of relative performance. We beat the Russell 2000 Value benchmark by over 1,600 basis points in our small cap value product. We strug-

gled a bit the prior year, through the junk rally where lower quality securities were outperforming. But we always feel that, going back to our overall philosophy, which I mentioned earlier, we feel very much that higher quality outperforms over the long run. So we felt it was important to stick to our knitting, and what we found toward the end of 2006 was that the higher quality stocks were basically trading

buying back their stock or paying out dividends or making acquisitions or paying down debt. You can only do those things if you are generating excess cash from your business. So that is something we focus on a lot. We also look for strong balance sheets and a proven management team that we believe is acting in the best interests of shareholders. Those would be some of the common characteristics.

*“On the consumer side, a name that I like a lot that we have owned for about a year now — it has turned out to be a great retailer through this crisis that the industry is facing — is TJX. The stock is not as cheap as some of the other retailers, but its valuation is reflective of the fact that it’s a leader in its industry and that it’s such a high quality player. It’s valued at about 8 times EBITDA and throws off tremendous free cash flow.”*

at the same valuations as the lower quality stocks. Risk premiums in the market narrowed dramatically and people were taking undue risks and not getting paid for them. So we just continued to upgrade the quality of the portfolios, and then that paid off significantly for us throughout 2007 as fear re-entered the mindset of investors and risk premiums widened. So our style of investing in higher quality really paid off for us and our clients.

Looking forward into 2008, we see a continuation of this; clearly the economy is weakening. I think we are likely either in or going into some type of a recession here, particularly on the consumer side. I would argue that the consumer already is in a recession. And I think that that type of environment plays well into our style where people are concerned about risk. You see risk premiums rising in the market, and that gives a manager like us that has been around a long time and been through several of these environments — it gives us the ability to capitalize on that fear and uncertainty in the market and continue to outperform the benchmarks with a very high quality approach.

**TWST: What are the investment criteria that your investment team specialists look for in potential holdings? Are they different according to each sector or do you look for certain criteria in common?**

**Mr. Geller:** For the most part the criteria are similar. What we are looking for are companies that are market leaders with a strong position in a particular business, stable to improving fundamentals, above average profitability and asset utilization characteristics. We look for significant free cash flow generation; that is very much a common theme across everything we do. Free cash flow is very important because that is really the key tool that empowers management to enhance shareholder value, whether it is through

1-Year Daily Chart of TJX Companies



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

And then each sector specialist has a particular quantitative model that they work with in their sector and a lot of the criteria are similar across the sectors. We are looking for stocks that trade at low valuations on enterprise value to EBITDA, price to earnings, price to book value, price to free cash flow, and then on the profitability side we are looking at companies with above average margins and return on assets, and we also look for companies that are spending their capital appropriately. We prefer companies that are reducing their capital spending plans, as opposed to companies that are undertaking a huge spike in capital spending, or getting too aggressive on the acquisition front.

**TWST: Looking at the different sectors, have you made any change in emphasis over the last 12 to 18 months in the portfolio composition?**

**Mr. Geller:** We haven’t made a major change in the emphasis of the characteristics that we look for. One of the things that

we have moved toward over the past year or so is we are running the portfolios with tighter sector bands relative to the benchmark. What I mean by that is that we are not, as a group, making large market timing or sector rotation bets within the portfolio. We feel that as a firm our core competency is on the stock-picking side. Really what we want to do is neutralize or come close to neutralizing the sector allocation aspect of the equation and really focus in on our core competency, which is the stock picking. So we run the portfolios with sector bands that range anywhere from 75% to 125% of the relevant sector within the benchmark, and we then try to generate our outperformance through superior stock picking on a sector-by-sector basis.

And going back to what I said about our performance in 2007 in the small cap product, virtually all of that outperformance that I mentioned did come from stock picking. So the strategy is working.

**TWST: How many holdings generally would you like to have in your different portfolios?**

**Mr. Geller:** It really varies quite a bit. Our all-cap and mid-cap portfolios are generally more concentrated. They each have about 35 stocks. The smaller cap portfolios have more names partly for liquidity reasons. So our small cap product has typically 60 to 70 names and our micro-cap typically 70 to 80 names. Then we have the hedge fund, which actually has over 100 positions in it. We have

**TWST: Would you tell us about some of the companies that you think are representative of your investment approach and the reasons why you found them attractive, perhaps from different capitalization portfolios?**

**Mr. Geller:** Just by a way of background, I follow the retailers and the capital goods companies, so I will give you a few examples. On the consumer side, a name that I like a lot that we have owned for about a year now — it has turned out to be a great retailer through this crisis that the industry is facing — is **TJX** (TJX) and **TJX** owns several underlying retail chains. The ones that are most popular are T.J. Maxx and Marshalls. They also own HomeGoods, which is an off-price retail concept for home-related items. They own A.J. Wright, which is kind of a lower end version of T.J. Maxx, and they own a couple of similar concepts up in Canada called Winners and HomeSense, and also T.K. Maxx in the UK. Basically this company has been able to capitalize on a lot of the problems in the retail and apparel sectors, because as an off-price retailer, T.J. Maxx goes and buys the excess production runs and inventory that other players have too much of — T.J. is able to go in and buy high quality brand name merchandise at a substantial discount to take it off the hands of these other players. They can then go and sell that merchandise to their customer base at a very attractive price, a much lower price than their customers would be paying in the department stores or at other

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about 50 to 60 names on the long side and then also about 60 names on the short side. Right now it is running about 115% long, 65% short. So the total market exposure is about 180% and the net market exposure is about 50% and on a beta-adjusted basis, that net market exposure is between 30% and 40%.

We also run one very highly concentrated product, which I have not mentioned because it is relatively small. We call that Ultra Value and it is the best ideas of the firm. It is our 10 best stocks and that is a product that we run for the most part internally, but we think, as the investor universe continues to look for high value added, concentrated products, that Ultra Value could be something that interests people.

**TWST: Is that an all-cap portfolio of ideas?**

**Mr. Geller:** Yes.

1-Year Daily Chart of Bed Bath & Beyond



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

specialty retailers. So it has been a perfect type of concept to capitalize on this treacherous retail environment we are seeing.

The stock is not as cheap as some of the other retailers, but its valuation is reflective of the fact that it's a leader in its industry and that it's such a high quality player. It's valued at about 8 times EBITDA and throws off tremendous free cash flow. They have a terrific balance sheet. They buy back their stock consistently. It's really run by a terrific group of merchants and managers who do the right thing for shareholders.

**TWST: That's great — to have a consumer discretionary stock, particularly in these times, that you can have confidence in.**

**Mr. Geller:** Another one I bought recently also that I view to be an extremely high quality player is **Bed Bath & Beyond**

which is a higher end Italian concept. And what I like about **Brinker** is that the management team has been very aggressive in monetizing fixed assets and using that cash flow to benefit shareholders. They have initiated a very substantial share repurchase program. I believe they bought back over 15% of their shares outstanding in the past 12 months, and I think that they will continue to do that. Right now, the Macaroni Grill chain is up for sale and the company thinks that by mid-year they will have that sold. I think they will use the proceeds from that to continue on that share repurchase program, so that over time, as the consumer rebounds and they begin to experience better performance at their other chains and begin to grow the earnings of those chains again, the remaining shareholders get a much larger proportion of that future earnings growth. So I like the concept of what management is doing.

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(BBBY) and they are in a little bit of a tougher market right now for the type of products they sell. Considering the significant slowdown in home turnover, a lot of the products they sell play into this market, but this is without a doubt the premier player in that business, and I think they are going to be able to capitalize on the weakness we are seeing at some of their competitors. For example, Linens 'n Things, which was LBO'd about two years ago, appears to be in significant trouble. We've also seen Sears really struggling and one of the areas that's hurt them a lot is their home goods department.

So **Bed Bath & Beyond**, while it's in a tough environment right now, is trading at a very attractive valuation of roughly 6 to 7 times enterprise value to EBITDA, which is several multiple points below its historical trading history, and I think they are going to be able to benefit from a retraction of square footage in the business that they are competing in. Their leadership position will only grow in time and you are able to buy the company at basically the cheapest valuation it's ever traded at.

**TWST: What about restaurants and the retail area? Have you found anything in that that's going to withstand this consumer recession?**

**Mr. Geller:** Yes. One restaurant that I bought very recently is **Brinker** (EAT). Chili's is their flagship chain. They also own Macaroni Grill, On The Border Mexican Grill and Maggiano's,

1-Year Daily Chart of Brinker International



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

Another thing they are doing is some franchising. They are taking company-owned units and selling them to franchisees. So they are taking capital out of the business. They are generating cash from the sale of those units but they will continue to get royalty fees paid to them over the years by the franchisees. It continues to be a profitable business but they are able to do it with a much lower capital base, so theoretically they should grow their return on capital over time and be able to return that cash to shareholders as well.

They have raised their dividend pretty significantly recently. The stock right now is yielding about 2.5%, which is above average for a retailer or for a restaurant chain and so the dividend that they initiated less than two years ago has grown nicely and you are able to buy this company for a less than 6 times EBITDA which, similar to **Bed Bath & Beyond**, is several multiple points below their historical average.

**TWST: What about the capital goods area?**

**Mr. Geller:** In the capital goods arena, one of my favorite large cap stocks right now is **3M** (MMM). They actually just reported earnings and it was a pretty good quarter. I view **3M** as one of

**TWST: Have you been looking at more companies that have international operations to take advantage of the weaker dollar?**

**Mr. Geller:** Yes, we have. Another good example in the packaging arena would be **AptarGroup** (ATR). This is a company that makes dispensing equipment and closures. They also have over 50% of their sales that are outside of the US. And they also have some markets that will perform better in a cyclical downturn because a lot of it is healthcare and personal care related, which are less cyclical than your traditional industrial markets. So **Aptar** is another stock that I like for a more defensive type of a play.

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the premier global industrial conglomerates. They have six main lines of business. It is really a very well diversified company. We all use a lot of their products all day long without even realizing it. It is an extremely high quality company. They probably have among the highest returns on assets of any industrial company out there, and they have been doing it forever. It is really attributed to how well the businesses are run and also to the incredible R&D effort that the company has. It has always been one of the most innovative companies in the US, and they continue to roll out many new products and receive patents on a significant number of new products across their different businesses every year. They have also been experiencing above normal growth overseas, so their international markets are growing faster than the US markets, and more than 50% of their revenues today are generated internationally. So that will buffer them somewhat through a US recession. And they are also buffered by the fact that some of their businesses are really non-cyclical; for instance, they have a pretty significant healthcare business where they have a strong position in the dental equipment market.

Once again, you are able to buy this at valuations that are about as low as it has ever traded at. Its enterprise value to EBITDA is about 7.5 times and on a p/e basis it is trading at about 14 times, and if the company continues to execute and gets back to traditional trading multiples, it should be at least a \$100 stock; it is currently trading in the mid-\$70s.

1-Year Daily Chart of Quanex



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On the smaller cap side, there is a company called **Quanex** (NX) that I think is in an interesting situation right now. We have owned the stock for a few months and we benefited from a partial takeover of the company. They are basically in two businesses. One is a steel business and the other is a building products business. A foreign steelmaker called **Gerdau** came in recently and made an offer to purchase the steel business. So we are going to get just under \$40 a share in cash for the steel business. And this should close within the next two months.

What we are going to be left with is the building products piece. The building products division makes various types of products that are aluminum, PVC and wood-based, primarily for window and door components. A lot of it is sold into the residential housing markets, so it's certainly a depressed market, but I think that the valuation of the stub is grossly undervalued today. There is a tremendous opportunity here in my view. As I mentioned, we are going to get about \$40 a share for the steel business and the stock trades at \$50 so that means the remaining stub piece trades at about \$10 a share. From what I can tell and based on the company guidance, the earnings for 2008, which we all know is going to be a depressed year for the housing market, will be well above \$1 per share in earnings and probably \$1.50 per share in free cash flow. So you are able to get this for a price of roughly \$10, and the way the valuation works out, you are paying less than 10 times earnings, probably only 6 or 7 times

We also look to eliminate value traps before they really drag down performance over a prolonged period of time. And what I mean by value traps are those companies that might look cheap but they just don't go anywhere. They continue to get cheaper; they continue to sell off in price. There tends to be an underlying fundamental issue with those companies. Probably the hardest thing that a fundamental value manager ever does is sell a losing position from a portfolio because, by definition, it is probably going to look cheaper than when you bought it. But the evidence is very compelling that companies that have underperformed by the most over the previous six months, tend to continue to underperform. We have a very distinct review process for eliminating these underperformers from our portfolio and we instituted this formally about a year ago, and it has really benefited our performance, and helps keep the portfolios fresh at all times.

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free cash flow, and about 3 times enterprise value to EBITDA. So I could easily see this stub piece conservatively worth \$16 to \$18 per share, which is nice upside from here.

**TWST: What about the sell process? What triggers an exit from your portfolio?**

**Mr. Geller:** We typically exit a position if we feel that fundamentals are deteriorating or if we feel that the valuation to profitability trade-off described earlier is not as attractive anymore.

**TWST: How do you attempt to control risk? What are the risk management techniques you incorporate in your process?**

**Mr. Geller:** We have multiple layers of risk control in our process, the first of which is our valuation model itself. I referred to this somewhat earlier — each of the sector specialists has a valuation model that's applicable to their sector and this valuation model is a key tool that we use to measure exactly what I was just describing to you, and that's the trade-off between valuation, profitability, and financial strength. So the first layer of our risk control is constantly monitoring everything in our portfolio in terms of how it looks in our models.

Another item I just mentioned is deteriorating fundamentals. This is a very important aspect of the continuing fundamental analysis that we do on companies that we own in our portfolio. If we feel the fundamentals are deteriorating, we will sell those stocks.

1-Year Daily Chart of AptarGroup



Chart provided by [www.BigCharts.com](http://www.BigCharts.com)

We are also diversified by the number of stocks we own. I mentioned earlier in our small cap portfolio, it's about 60 to 70 stocks. We diversify it by sectors as well; as mentioned, we are not taking large sector bets. We are also diversified by sector specialists, since we have an 11-person investment team working on every product. If one or two individuals have a tough year then it's not going to kill the whole portfolio. Additionally, if somebody leaves

the firm, we don't have the key person risk that you see in firms that run with a more traditional PM/analyst structure. We immunize our portfolios from that risk by running them with all of the team involved. We also have a daily oversight by a specific team leader for each product. We do an in-depth monthly review of each product by the entire team where we go through every single name in the portfolio, paying particular attention to the underperformers. We put people's feet to the fire as to why they are sticking with those names as opposed to trading out of them for something that looks more attractive. So that's a long answer, but it's really this multi-tiered approach to risk control that's important to properly implement our investment process in the portfolios.

**TWST: What are the defining features of your investment approach at Dalton, Greiner, Hartman, Maher that distinguishes your process?**

**Mr. Geller:** Going back to a couple of things that were already mentioned, one distinguishing feature would be the attempt to isolate what we feel is our core competency, which is stock picking, so we are neutralizing a lot of the sector allocation decisions and associated risk. Also, the intense review of underperformers and value traps, forcing those names out of the portfolio — that would certainly be another distinguishing feature. I also just like to think that the fact that we have so many resources dedicated to the smaller end of the market cap spectrum is important. I feel that by doing bottom-up, fundamental analysis with a team of such experienced individuals, and by breaking it down by sector, we have the ability to really drill down into these companies. I think that is an important distinguishing feature of Dalton, Greiner versus the competition out there.

**TWST: Looking ahead, are there any challenges or potential problem areas that you think investors ought to be wary of?**

**Mr. Geller:** I think that the big movement to alternatives, private equity and international that we have seen by so many investors over the past few years may turn out to be a lot of people just chasing performance and ending up getting burned in the long run. A lot of the products that are in market segments that people have been

chasing don't perform well when they get flooded with capital, and I think private equity is a good example. A lot of these private equity firms just got inundated with capital in the past few years and they went out and started doing bigger deals and riskier deals because they had to try to put up the returns for investors that they had done historically. Now you are seeing a lot of those deals unravel. I referred to Linens 'n Things earlier; that is a perfect example of a potentially failed buyout — there is a chance that company is going to go bankrupt. We have seen multiple companies that were just LBO'd in the last year that are falling apart already.

So I think that a lot of that money that went chasing product performance could at some point turn back around, and start coming back the other way. And we would hope to be able to take advantage of that, because I think our product line is proven over the long term. It has been battle tested for 25 years through various types of market environments, and every one of our products has a benchmark-beating return over both the short- and long-term time periods. I would hope that we can take advantage when that tide turns a bit.

**TWST: Thank you.**

*Note: Opinions and recommendations are as of 2/4/08.*

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