The No-Load Fund Investor

INTERVIEWS

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Sound Shore Fund *(800-551-1980; soundshorefund.com; $10,000 minimum initial investment, but sometimes less through no-load fund supermarkets) is one of the finest funds of which you've never heard. That's because instead of creating and marketing new funds with various investment styles, the folks who run the fund focus on its management and on one particular type of stock for the fund and institutional accounts alike: out-of-favor, yet quality, companies.*

T. Gibbs Kane Jr. and Harry Burn III launched Sound Shore in 1985. In 2003, they were joined on the fund by John DeGulis, who had joined Sound Shore Management as an equity analyst in 1996. Over the 10-year period ended Aug. 29, 2008, Sound Shore Fund produced an annualized gain of 8.5%, vs. 6.1% for the average return of the funds in Morningstar's Large-Cap Value category. Over the five-year period ended that same date, Sound Shore Fund generated a 9.6% annualized gain, vs. 7.2% for the average; over the one-year period, the fund lost only 4.6%, vs. a loss of 14.6% for the average.

Generally, investors in Sound Shore Fund have benefited greatly over the years from a disciplined investment style in a relatively concentrated package of about 40 stocks, diversified across many sectors. The managers have avoided investment fads and kept volatility modest. For more info on Sound Shore Fund, including how it has managed to do so well during the current year's tough environment, see my chat, following, with John DeGulis.—**Mark Salzinger**, Editor and Publisher

▶ John, what defines a stock as out of favor?

First is the absolute performance of the stock over one and three-year periods. It's also going to be its valuation, so we look at price/earnings, price/cash-flow and price/book-value ratios on an absolute basis and relative to a company's own history. That gives us an opportunity set of stocks that have underperformed and are cheap relative to their histories.

▶ Sound Shore has said that it invests in stocks that have "lost their Wall Street sponsorship." What does that mean?

If a company has underperformed, the stock will likely be down and investors will have lost money. After initial disappointment, we often see a lack of attention. Sell-side analysts in Wall Street look at stocks they think are more certain or near term. "Growth" investors have sold, and maybe some early value investors have gotten in but the stock is just sitting there without a lot of movement or new news. In this kind of situation, there tends to be a lack of attention.

▶ Tell me more about the specific tests you and your co-managers use to pick stocks.

The first is identifying what's out of favor on a valuation basis and a performance basis. For the most critical valuation ratio for each company, we establish what we consider to be a normal range. The discount needs to be at least a third from the average.

We spend a tremendous amount of time analyzing the earnings and the earnings drivers. We do our own modeling. We forecast future earnings the next four quarters in detail, and then we'll often go another year out depending on how far off the company is from its normalized earnings track. We spend a tremendous amount of time understanding where they are in terms of their return cycle, leverage ratios and growth rates, including the level of earnings predictability. We compare those to what we think are consensus estimates.

Not only is it forecasting the earnings number, but also trying to identify the most critical variables. Sometimes they are obvious; oftentimes, they are not the way a company reports its sectors or segments.

▶ How do you get from stocks that appear statistically cheap to the 40-or-so stocks you have in the portfolio?

We start with the largest 1,250 stocks, which is about $3 billion and up in market capitalization. With the screening, the bottom two deciles [20% in total] in terms of valuation equate to approximately 250 stocks. We then do a value check, in which we complete a more thorough valuation exercise in which we look at where the company may be in terms of its earnings cyclicality. A classic example would be a cyclical stock that has a cheap P/E, but whose earnings may have tripled over the past five years and are about to fall. In fact, the low P/E would coincide with the exact wrong time to buy the stock. Our value checks screen out the false positives. That whittles our list down to 80 or 100 stocks, where we dig in with a team of seven people for the fundamental research, which accounts for most of the actual work.

We contact the companies, visit them, and have a relationship with the management teams. We talk to as many unbiased primary research contacts as we can drum up, including board members, competitors and suppliers. The 80 to 100 purchase candidates get whittled down to the ones we think present the best risk/reward opportunities.

▶ How do you define risk/reward?

It's driven mostly by the valuation work we do at the beginning, which helps measure the degree of the opportunity of a potential investment if the company returns to a normalized earnings number and valuation. And, if we're wrong, the degree to which the stock has fallen relative to those same measures. Also, we figure in the predictability of the earnings stream, the quality of the business and whether or not the management team has been time tested.

We are not a classic turnaround investment shop. You will find a handful of turnarounds, or restructurings, in the portfolio from time to time, but we are not "deep value." It's going to be three or so out of the 40 holdings.

We are very cognizant about taking risks we understand. We don't like to take multiple risks simultaneously. What I mean by that is, if a business has some degree of leverage—not uncomfortable, but certainly they need to get the debt paid down—we spend a lot of time looking at the stability of the cash flows. Here's an example. Coming out of the energy-merchant debacle of Enron, El Paso Corp. had a failed energy-merchant business that dragged the stock down. They were over levered, yet underlying that business was the largest investment in a very stable business: interstate gas pipelines. In fact, they had plenty of cash flow to pay down the debt and transfer value from the fixed-income holders to the equity investors. We're happy to take that kind of risk.

If there's operational risk in a company with leverage, we will not get involved until the balance sheet is fixed.

▶ In what areas of the market are you and your fellow co-managers finding attractive purchase candidates today?

It's pretty diverse. We don't like to lean too heavily on any one industry, so we limit ourselves to 25%. In a market such as today's, where the average stock is down, the list of

Sound Shore Fund

Yearly Returns

	'04	'05	'06	'07	'08*
Sound Shore Fund (SSHFX)	15.3%	6.8%	16.6%	2.6%	–3.7%
Avg. Large-Cap-Value Fund	13.0	6.0	18.2	1.4	–12.7

*Through August 29. Source: Morningstar.

prospects is quite long. Given the uncertainties on the economic front, we're being very selective.

We have seen a number of interesting new opportunities in healthcare and even some in financials. We also are finding some interesting names in consumer discretionary. Given all of the pressures on the consumer, those stocks are down quite a bit. Not all of these businesses' prospects move together. So, this is the kind of dislocation of which we try to take advantage, where an entire sector may be down but we can find some stocks that are not damaged and are doing quite fine. At least, they may emerge on the other end of the cycle in much better shape.

▶ By the tests you and your co-managers use to pick stocks, what are some of the fund's most attractive holdings?

Boston Scientific is an interesting, extremely attractive stock in which the fund has a full position. It's a medical-device maker. Boston Scientific bought Guidant three years ago for a very hefty price. At that time, Boston Scientific was trading at $25, down from $50. Now it has come down into the low teens. So, any destruction in value from having overpaid for Guidant has more than been taken out of the stock price.

So, now you have the former Boston Scientific and the former Guidant together in what is a more diversified company that has leading positions in cardiac-rhythm management (including ICDs, defibrillators and pace makers) and stents. Post-merger, the issues hurting the stock have largely been external. The management team has been executing very well. The new products are good, and the company's market shares have held nicely. What has happened is that their end markets have slowed quite a bit. What were 10% to 20% growth markets are now in the low single digits, so the combined company is fighting for market share in a slow-growth business. Having said all that, they are ahead of their plan of paying down debt. They are generating free-cash flow, and they have multiple engines for growth. Their cost structure is coming down rapidly. In six to 12 months, the market-share battle within stents will settle out. Boston Scientific will have a very good chance of having at least 35% market share. If that turns out, we see Boston Scientific with at least $1 of cash earnings per share for a stock that's trading at $12.50. So it's extremely attractive.

In consumer discretionary, we have stayed away from companies that sell to consumers who require a loan to buy the product. We don't have any autos, appliances or housing. Comcast is a good example of what we do own in this sector. The stock fell nearly 50% last year; we got involved about three quarters of the way through last year. The stock got down to below 6.5 times cash flow, which is an extremely low level. They were finally getting their arms around their capital-expenditure growth and being a lot more efficient in returning capital to shareholders. They announced a dividend this year and also a share repurchase. The battle between the cable companies and the telecom companies, although certainly not over, is stable at the moment. Based on the last six months of data, the cable companies are taking share in high-speed hookups and also on the phone side. So, for a business that is growing cash flow in the high single digits, the multiple today is very attractive.

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▶ When are stocks trimmed or even sold outright from the fund?

By and large, it is dictated by the valuation framework I mentioned. We establish a target price based on normalized earnings multiples. When the stock reaches that price, it is a sale candidate. The target is based on what we consider to be fair value with a normalized earnings multiple. It's on forward earnings, so it's a dynamic number.

▶ Is there anything special about maintaining a portfolio of about 40 stocks as opposed to a smaller or larger number of holdings?

It has evolved over time. We have very consistently been between 35 and 50 stocks. The top 20 stocks in the fund will be around 60% of the assets. We have a big chunk of the holdings right at 3% weightings. That has always been the case. It is a good risk/reward on an absolute basis. When we make mistakes, it's very rare that we would lose more than a percentage point. Given our style over time, we think it maximizes our return relative to volatility.

It's not a hyper-concentrated portfolio where one name can ruin your year or destroy capital. But it is concentrated enough where it is true active management.

▶ Are there any other steps that you and your co-managers take to limit risk in the fund's portfolio?

We limit any position to 5% at cost. It's rare that we've been even over 4% at market since I started here almost 14 years ago. I think the most we've had in any one sector since I got here has been financials, probably eight years ago, in the 25% range.

▶ How important to you is global reach among your fund's holdings?

We invest in larger companies. It's important to us to have businesses that are growing and doing well. Given the maturity of the North American economy, a lot of those opportunities are abroad. The good news is that some of the cheapest global stocks are right here at home, whether it's a General Electric, Symantec, Marsh & McLennan, Boston Scientific or Baxter International. These are big businesses that compete all over the world.

▶ How do you, your co-managers and the analysts divide up the responsibilities on the fund?

We are all analysts at heart. We all like to have direct responsibility for doing the fundamental research. It is not an organization where the analysts type up reports and slip them under the portfolio manager's door. It's a team process. All seven of us are doing direct research. We assign two people to each stock in the portfolio, and then there is a "shadow" portfolio of other names on which we are doing a lot of work. So, about 80 stocks have a team of two. Typically, it is a portfolio manager and an analyst who work together in partnership on the stock.

Then, the three portfolio managers work in unison to do any sort of cash management, risk management, assessment of the portfolio, and to break disputes from time to time. There is no formal investment committee. We like the decision making to be pushed down to the folks who are actually doing the work and are responsible for the fundamental analysis.

▶ Do you have any kind of yield requirement?

No. We look at dividend yield only in the broad context of shareholder capital. We are very focused on free-cash flow, or what we refer to as discretionary cash flow. In some companies, the best use of discretionary cash flow is dividends. In others, it's share repurchase.