

# THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

## Investing in Small Cap Value Stocks



**RICHARD A. GIESEN JR.** is the Founder, Chief Investment Officer and Small Cap Team Leader at Elessar Investment Management. In his role as Chief Investment Officer, he oversees all aspects of the investment process and manages the firm's research efforts. He began his career as a portfolio manager and equity analyst at Lazard Freres Asset Management in 1986. In the past 10 years, he was hired by three separate financial service firms in the Midwest to assist in the management or become the lead manager of the small cap value product. His market-tested experience and expertise in the development of a consistent, repeatable and quantifiable stock selection process were implemented at these firms in order to address and resolve

issues of lackluster performance and/or ineffective stock selection methodologies. After he joined the team, each of these products subsequently performed strongly in terms of investment performance relative to their benchmark and peer groups, and in terms of asset growth and retention goals. The peak of the assets managed by Mr. Giesen was \$1.5 billion. At each firm, he effectively marketed his investment products to internal and external constituents. He holds a BA degree in Biology from Grinnell College and an MBA from Northwestern University in Finance and Accounting

### SECTOR – GENERAL INVESTING

**TWST:** Would you start with an overview of Elessar Investment Management and its investment philosophy?

**Mr. Giesen:** Three of us left National City Bank in 2005 to launch the firm and our small cap value product. Free of the administrative issues often associated with a much larger organization, we wanted to establish a boutique investment management firm solely dedicated to small cap value investing and reminiscent of the entrepreneurial spirit I found during my days at Lazard Freres Asset Management, starting in 1986, when I was a member of its original small cap value team.

Elessar's small cap value product was launched on April 1, 2006, with the philosophy and mandate of purchasing high-quality companies on a price-adjusted basis. We define quality as a cash flow driven return on capital. We believe measuring a company's level of financial productivity this way, versus using a reported return on capital calculation, properly adjusts for accruals and, thus, eliminates any earnings manipulation inherent in reported earnings. We have a fairly concentrated portfolio of companies.

**TWST:** It's been a difficult year for all types of investing. How have you been able to deal with the market turmoil and the economic environment with your small cap value outlook?

**Mr. Giesen:** Our value investment process purchases companies for what they are today as opposed to a growth investor who may be looking to buy companies for what they could become.

Our most important reference point is what the company has done in the past in terms of generating a consistent level of financial productivity as measured by the cash flow driven return on capital that I mentioned earlier. Analyzing a company's financial statements over the past three to five years reveals for us how successful a company has been growing its enterprise in tandem with the appropriate capital structure and, thus, how well a management team has navigated their business model through an economic business cycle or a commodity pricing cycle. We also wish to identify catalysts that will allow this company to sustain its high level of financial productivity going forward on an organic basis and not just from cost cutting. In all, our bottom-up fundamental research process gives us confidence in which companies represent a reasonable risk during these tumultuous market and economic conditions.

Even though we went through an environment where the economic conditions were the worst since The Great Depression, our companies on average did quite well during the last four quarters. Our portfolio's strong relative performance can be highlighted in some of the characteristics of our portfolio.

For example, earnings performance of our companies is down on average by only 14% over the last 12 months, versus nearly a 50% decline in earnings for our benchmark, the Russell 2000 Value Index. I would point out the level of financial productivity, as measured by ROE, of our holdings on average was 9.4% compared to less than a 1% return generated by the Russell 2000 Value Index and despite the fact that our companies had less balance sheet leverage, as measured by debt to capital ratios, than the benchmark.

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**TWST:** Approximately how many holdings do you have in the portfolio?

**Mr. Giesen:** Approximately 40.

**TWST:** What are the sector allocations?

**Mr. Giesen:** Our stock selection process is based on fundamental, bottom-up research and not sector bets. Having said that, we put parameters on our portfolio in order to manage risk by not overweighting or underweighting the Russell 2000 Value Index sector weightings by more than 750 basis points.

**TWST:** What areas do you have the most exposure in?

**Mr. Giesen:** The financials sector is approximately a third of our benchmark, and so that is the largest exposure for our portfolio as well.

**TWST:** Would you give us some idea of your holdings?

**Mr. Giesen:** Certainly. **Central European Distribution Corporation** (CEDC) is the largest producer of vodka and other alcoholic beverages in Poland, Russia and Eastern Europe. This company has a dominant market share, a management team that has executed very well over time by generating very high levels of cash flow and good levels of financial productivity. We felt that their acquisitions in Russia would allow them to expand very nicely in a market that continues to grow in the mid- to higher-priced brands that they sell.

Shortly after buying the stock in the low \$20s, short sellers pounced and cratered the stock below \$10. The rumors manufactured by short sellers suggested that some of the company’s recent acquisitions that gave it a large

*“The Buckle is in the teen retailer space, it sells mostly denim-related products to both men and women, and the management team are seasoned merchandisers who have consistently delivered the right products to their customers at the right price and at the right time. The company’s growth trajectory has largely been based on organic new store expansion and it could double its current store base by entering new geographic markets.”*

presence in Russia were not working out very well, the company was having difficulty collecting its accounts receivable during these tough economic times and that demand was declining significantly across all of its market segments. During each leg down in the stock price, our research determined that the fundamentals were, in fact, getting stronger and playing out according to our original investment thesis. Our last purchase of the stock was below \$10 and we recently sold it for approximately \$29 a share.

Another representative holding is a retailer called **The Buckle** (BKE). It is based in Nebraska and we first identified this company over two and half years ago with our front-end stock screen that we run weekly against a universe of nearly 4,000 companies. At that time it was a bit too expensive for us as compared to other retailers; however, this company is in the teen retailer space, it sells mostly denim-related products to both men and women, and the management team are seasoned

**1-Year Daily Chart of Central European Distribution Corporation**



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

merchandisers who have consistently delivered the right products to their customers at the right price and at the right time. The company’s growth trajectory has largely been based on organic new store expansion and it could double its current store base by entering new geographic markets. **Buckle** has recently posted 22 consecutive monthly same-store sales gains in the double digits. Until recently, there has been very little sell-side research coverage on this company. We bought and sold the stock well on several occasions in the past 18 months.

**TWST:** Is there a third one?

**Mr. Giesen:** A third one would be **CommScope** (CTV). **CommScope** is in the communications technology arena, and approximately 60% of its sales are derived from wireless communications equipment. It provides products to the wireless industry for antennas, transmitter base stations and cable. The wireless exposure primarily comes from the acquisition of Andrew Corp. several years ago. The

addition of Andrews to the sales mix has positively changed the dynamics of this company and its future growth trajectory. The company has seen a lot of growth in the wireless arena here in North America and overseas as well, particularly in India and China. Management indicated to us and other investors earlier this year that their growth in wireless equipment orders is very solid. This company was also the target of short sellers late last year and earlier this year because of concerns over the company's relatively high debt balances. However, they have enough cash on their balance sheet and under dire situations could raise cash through some asset sales. We are comfortable with their overall capital structure and believe they're able to live within their debt covenants. When the stock was under pressure, given concerns about the economy and their balance sheet, short sale rumors about the company's demise were not accurate. We stuck with the stock, added more to it and recently sold it in the mid-\$20s.

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**1-Year Daily Chart of CommScope**



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

**TWST: Would you say that you have a contrarian bent to your value philosophy?**

**Mr. Giesen:** Not necessarily. When I think of contrarian style investing, a value investor can often find himself in a value trap or a deep value situation, both of which we attempt to avoid here at Elessar. However, we're not afraid of investing in companies that are not widely held or are not widely followed by Wall Street. It's important for us to find the appropriate quality/price dynamics and the catalyst(s) that we can understand and believe will provide incremental upside to the story.

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

**Mr. Giesen:** There are several factors that can trigger a decision to sell. We establish price targets on all of our companies. The price target is a reflection of what we think is the upside to the story, based on

our fundamental research. Once a stock exceeds that price target and we cannot justify raising that price target based on the fundamentals, we will trim that holding by approximately 25% and let the rest run on momentum. If there is momentum behind it, it will establish a higher price or period high. We only know the period high stock price in retrospect. Whenever the stock trades off 5% to 10% down from its period high, we will sell the entire position and before it moves through the original price target. We also watch underperforming stocks as compared to our benchmark on a rolling one-month and two-month basis so that we eliminate the "slow bleeders" or stocks falling gradually and almost unnoticeably on a daily basis. Lastly, we also sell the position when it is down from average cost by 30% and the company fundamentals have not improved. We believe that the sell discipline not only helps limit our investment losses, but it also eliminates the emotional decision making, i.e., fear and greed, normally associated with investing.

**TWST: What is the average turnover and was the turnover more because of the market conditions over the last year?**

**Mr. Giesen:** The turnover of the portfolio is directly related to our buy and sell discipline and on average has been about 100% per annum. Because of the volatile market conditions during the past 12 months, we implemented "circuit breakers" as part of our sell discipline. When a stock was down 30% from average cost, we also evaluated its performance relative to the average performance of its sector and group. This enhanced sell discipline during volatile market conditions has effectively reduced the amount of turnover from what would otherwise be the case.

**TWST: Do you look for international stocks that fit your investment criteria?**

**Mr. Giesen:** Our universe is comprised of all companies between \$150 million and \$2.5 billion in market capitalization that have a minimum average daily trading volume of \$500,000. We do not necessarily look for foreign companies per se. However, our average holding has approximately 25% of its total sales generated from international markets.

**TWST: What do you think gives an edge to your small cap value investing? What are the differentiators between Elessar and peer companies?**

**Mr. Giesen:** There are several things that make our firm unique in the small cap value arena. Firstly, experience is paramount to good small cap stock selection. The experience factor is very important in all areas of investing, particularly as it relates to small caps because the largest constituent in our benchmark is approximately 50 basis points. Thus, it's very difficult for an active small cap manager to "closet index" his portfolio without buying hundreds of stocks. Because of our extensive experience in small cap investing, we like to say there aren't many small cap companies that we haven't owned or looked at before.

In terms of performance, it all boils down to what amount of excess returns we can generate above our benchmark. Taking that one step further, our institutional and individual investors look at how much of that excess return is coming from stock selection as opposed to sector allocations. Since the inception of our product, the vast majority of our excess return, or alpha, has been generated from stock selection. This strong relative performance has placed our small cap value product in the top 10% of our peer group.

Secondly, we have a very efficient front-end model that screens our universe of potential investment holdings looking for good quality companies on a price-adjusted basis. We believe this proprietary model effectively replaces the need for one to two full-time analysts. It does a very good job for us by “teeing-up” portfolio candidates with the highest probability of outperforming the market and then they are subsequently vetted by our bottom-up fundamental research analysis.

Thirdly, our fundamental research process is strong and unique. Unlike other teams that I have managed or been a member of where the investment team will divide up the sector coverage among the individual members of the team, each one of us here at Elessar looks at the same company at the same time, reviews company financial and proxy statements at the same time, and speaks with company management and sellside analysts at the same time. This research methodology creates a more dynamic and robust vetting process than anything I have been involved with before. This process prevents critical information from falling between the cracks because there is a constant dialogue with a series of questions being raised among the team members during each step of the due diligence process that otherwise may not have occurred if each team member was responsible only for certain sectors and essentially was working in isolation from the other team members.

**TWST: Looking ahead, are there any headwinds that you see ahead that small cap value investors should be aware of?**

**Mr. Giesen:** Coming into this year, we thought there were two factors that were necessary for good stock market performance: an easing of the high level of risk aversion and banks willing to extend credit again. I certainly believe that the first factor has taken place as investors have come back to embrace risk and small caps have done quite well during the first half. However, the banks still are not willing to extend credit because their lending standards and requirements have risen significantly. Thus, this latter factor could cause the economy to remain in a stall pattern and raise concerns about small cap performance as most investors perceive small cap companies to be overly reliant on bank credit. While this perception is largely correct, I'd like to point out that a company's ability to self-fund its capital requirements from operating cash flow is an important attribute for the companies that we own. This self-funding characteristic is one of the factors that have allowed our portfolio companies to perform well during these tough economic and market conditions.

**TWST: Thank you. (PS)**

*Note: Opinions and recommendations are as of 7/23/09.*

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