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By TONY CARIDEO

What's It Worth to You?

IS THE MARKET STILL A GOOD VALUE FOR VALUE INVESTORS? FRED SPEECE SAYS YES.

Some things change; some don't. The idea is always to adjust.

In the past four years, Fred Speece, of Minneapolis-based Speece Thorson Capital Group, has watched the stock market bubble burst and valuations across the board hit the bricks, providing him and other "value" managers with a rich lode of opportunities.

Speece, along with colleagues Ken Thorson, Paul Pender, and Ben Johnson, manages $350 million in assets. Being value investors, the firm focuses on companies that are financially strong—particularly their balance sheets—but may be out of favor because of a cyclical downturn.

But valuations have come up, as have earnings. Are we again nearing a point in the market where growth-stock managers will reign supreme?

We last spoke in June 2001. Have valuations tilted toward growth managers since then?
Today, the growth-value gap has narrowed, but value has always had a leg up for better returns. What may be just as important, or more important, is the market capitalization of stocks. Larger-cap stocks seem to still be overvalued and mid- to smaller-cap is the opportunity.

Why is that?
Valuation! Plus, because of what's going on in the investment business. The capacity of sell-side research to add value is shrinking because of a structural change in the business of research.

Investment banking has been separated from research, as much as it can be, as a result of the misdeeds during the Enron period. The only source of income for sell-side research now is commissions, so the economics of sell-side research has deteriorated. They can no longer afford as many analysts with big budgets, or the very expensive analysts. And an analyst's ability to effectively cover a company has shrunk, so we have fewer analysts, more junior analysts, less resources following fewer companies. And where do they gravitate? To the commissions: large-cap. Now they find themselves in the most efficient part of the market, trying to add value, which is going to be very difficult.

That's the negative side. The big positive is that they have left the mid-cap area, particularly the value side, where they were never very big. This exit creates an opportunity for money managers and independent analysts to do their own research. In short, the mid-cap value area is less efficient and loaded with opportunities for those willing to do the extra work.

How do you get to a point where that stock goes up in value and you're able to add value as a manager?
First, you need to prove to yourself that it is a value situation, and then invest in it. It may take longer, but if your analysis is correct, the results will pull the stock higher and you will earn very attractive returns. Second, the management of the company has a vested interest in shareholder value and the company's cost of capital, and now needs to find a better way to tell their story to potential investors.

How do you define mid-cap?
$400 million to $10 billion. The normal company in our portfolio is between $2 billion and $3 billion. We manage a concentrated portfolio of 30 to 35 companies which meet three criteria: well managed, financially powerful, and attractively priced. We want good companies with good cultures, and a history and ability of performing well above their peers, but that for some reason are currently not valued as if they can do that again. That reason tends to be more industry related rather than company specific.

We've had three years of stop-and-start economic recovery, where profitability has increased but has been driven primarily by lowering costs. How has your performance fared given all this?
Our performance has been good. The valuations still underestimate the earning power of the companies in which we invest. Their earning power is underappreciated because we have not had a very robust, consistent economic recovery. We've had fits and starts of inventory cycles, and the industrial side of our economy has undergone a secular [i.e., deep-rooted] consolidation. These companies have right-sized and have enormous earning power. What they need is volume.

What do you think might turn things around?
We're starting to see companies exercise and achieve pricing power. Not many can do it, because everyone is resisting price increases. But the real value-added companies do have pricing power. Leggett & Platt [NYSE: LEG] is a manufacturer that uses a lot of steel in their production process. Steel has gone up 60 to 70 percent in the last year, and Leggett's margins in the last two quarters have actually held the same or expanded despite higher raw material cost. They have pricing power because they have value-added products and services, and their customers are willing to pay more for that dependable, quality, on-time product.

But didn't they have that before?
They did, but they've never had the volume increases and the raw material price increase put together. Within the last six to 12 months, a lot of commodities—paper, steel, gas, oil—are on the rise. This is why Greenspan is raising interest rates. Inflation is starting to show its head at the base level. Companies experiencing that either have pricing power or they don't, and it's very clear to see who has it.

Who else in your portfolio are you seeing this with?
Pricing power exists at Engelhard [NYSE: EC]. They're a manufacturer of catalytic converters. They have value-added products and the number-one market share as well. Their raw material costs have been increasing, but they've been increasing prices to maintain their margins. This is something investors should be willing to pay for, and we believe the stock price understates their abilities.

Has your portfolio changed over the past three years?
We have increased our investment in companies that are industrial-based, [as well as] energy and oil service [companies]. We have decreased our financials and utilities.

Is that why you underperformed last year?
In 2003, we had excellent returns and our clients were up 30 percent. Last year was interesting, as the market was led by low-quality companies—a 'junk rally,' not our niche. We invest only in high-quality companies because we believe they produce the best long-term returns. As a result, we trailed our benchmark last year.

Do you own any local stocks?
We don't own any Minnesota companies. We love Minnesota, but Minnesota's economy is dominated by technology, 'growthier' kinds of consumer products that currently don't meet our valuation standards. In fact, that structural benefit to Minnesotans means that by definition, we're probably never going to own too many Minnesota companies. At one time, one-fourth of our portfolio was in Ohio, industrial companies that have survived the most wretched restructuring, outsourcing, and they're still in business and they're making more money, because they've learned how to compete on a global basis. It's a big cycle, but that's what is going on. And the U.S. still has some of the best industrial manufacturers in the world—it's one of the few franchises we have left. ■

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