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WHY YOU SHOULD BUY THIS UNIQUE FUND

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Last year, I recommended the Gabelli Focus Five Fund (GWSIX). Since I published that story on June 1, 2012 the fund is up 32%, easily outpacing the market's 22% gain. I recently caught up with portfolio manager Dan Miller and got an update on the fund as well as his thinking behind two favorite ideas.

If you missed it the first time around, you have another chance, as I expect the fund to continue to outperform by a healthy margin. Below, you'll see why.

The fund takes its name from the firm's famous Focus Five reports, which published the firm's five best ideas every quarter. The stocks published there notched a 210% total gain from January 2006 through October 2011, versus a negative 5% return for the market overall.

As you may recall, Gabelli no longer publishes this report. Instead, it created the Focus Five Fund, which aims to create a high-conviction, "best ideas" portfolio by drawing on the same kind of research process that produced those winning reports. The strategy has been in place since the beginning of 2012, when Dan took the helm. (Technically, the fund is not new, as Gabelli simply took an older existing small-cap fund and changed the mandate — and the manager.)

It was a tiny fund, as I noted at the time. By August, the fund had just $20 million of assets. Given the unique approach, there was a ready appetite for it. UBS added the fund to its platform in August. By December, assets under management shot up to $68 million. Good performance in 2012 helped bring it more attention and drive inflows. As of June 30, 2013 the fund has about $260 million in assets.

"It is important to note the inflows," Dan told me. "Because it really does have an impact on performance, on the structure of the portfolio and on tax efficiency." These inflows work to your advantage as a shareholder in the fund, Dan explained.

"First," Dan said, "the expense ratio continues to decline." Initially, the fund's fees were high, and I got some pushback from readers because of it. I knew that it would be worth it. I had been going to Gabelli's Best Ideas conferences for years. I had seen the quality of the ideas and had great respect for Dan and the research process, which I tried to convey in my initial buy. Now fees are not an issue. As the asset base has grown, the net expense ratio has decreased from 1.76% in January 2012 to approximately 1.20% as of June 30, 2013 on GWSIX, and that helps performance.

Dan also pointed out that a fund with such inflows is very tax efficient. He ran through an example: Think about the investors in the fund in December, when it had $68 million in assets. Let's say there was a taxable gain of $1 million. The tax impact would have been 1.5%. (That's $1 million divided by $68 million.) But the fund did grow. Today, that million-dollar gain would be only 0.04% of its $260 million asset base. There is much less of a tax burden for the investors who have been in the fund since December.

"It's a unique and overlooked benefit that accrues to funds that have inflows," Dan said.

"Now, of course, that could reverse at some point. We don't expect it to, given that we were just added to the Merrill Lynch platform. And we are not yet available on the Morgan Stanley platform. That probably won't happen until the end of July." Besides, the fund is still a small fish in a world where many funds have billions of dollars of assets.

There is another benefit to having strong inflows into the fund. It means the fund has cash to take advantage of opportunities without having to sell a position. Many fund managers without inflows would have to sell something to buy something, thereby creating churn and tax consequences.

This also affects the portfolio's structure. Most of the time, the largest positions in a fund are typically the ones that have gone up a lot or that the fund has owned for a long time. They are probably not the stocks that the fund would buy today. In fact, it may be trimming such positions or looking to sell them soon. Because of the inflows at the Focus Fund, this isn't the case.

"If you look at our top 10," Dan says, "these are stocks that we are actively buying. That's where you want your fund's focus to be. You want the ideas you have the most conviction in, the ones most attractively valued today, to be in your top five or 10 positions. I think that's a unique attribute to this fund."

There is a flip side to having such inflows. The fund often finds itself with too much cash. "In a market that goes up, as we've had in the last year and a half, too much cash can be a detractor to performance," Dan says.

In 2012, the fund was up 26.5% net of fees. But it held about 15% of the portfolio in cash, on average, through the year. This makes the strong performance of 2012 all the more impressive in my eyes.

"This year," Dan points out, "the fund is up about 14.6% net of fees. But we're averaging north of 20% of the fund in cash this year." The large cash position is a function of the inflows. It's also because the market is up and Dan hasn't been as aggressive as if the market were down 10%. Your editor sympathizes.

"We also have a very strict and specific methodology for how we allocate capital," Dan says. "And that will keep us from putting our money to work every day." Which is what you want — discipline.

Let's talk about that methodology. Dan sums it up in four points. First, the fund buys only fundamentally strong businesses. These are ones Dan would be comfortable owning in their entirety for five–seven years. Second, management must be focused on shareholder return. Third, the valuation must be extraordinarily compelling. The aim is for a price 30–50% below Gabelli's estimate of private market value. (PMV is what the business would be worth to a private buyer.) Fourth, the fund needs a catalyst that can surface in the next 3-18 months and unlock that value.

The fund has the ability to put 50% of its assets in just five stocks. (Hence, the name of the fund still applies.) Typically, it will hold 25–35 names, with Dan heavily weighting the portfolio toward the favorites.

You might think such a concentrated fund would be risky. You would be wrong.

"In fact, it's actually quite the opposite," Dan said. The beta of the fund is 0.62 since the Focus Five strategy has been in place. That means the fund has had little correlation to the overall markets. Dan refined this a bit more.

"If you look at the down months last year," he said, "there were three. We were down in two of them, and in both months, we were down less than the market. We were up in one." Alpha, which measures excess returns over the market, is over 14 — about as good as you can be. The fund's volatility is less than the S&P 500.

"We've taken a very cautious approach," Dan sums up. "The Gabelli Focus Five Fund follows a true fundamental, bottom-up stock picking approach that's driven by a really talented team of 35 analysts that have proven themselves for years at the Gabelli organization for being able to deliver really good ideas."

That's a good summary. It fits well, too, with what we do here with our CODE methodology. And it's why I love the fund and continue to recommend it to you as a way to supplement your C&C holdings.

TWO FAVORITES FROM THE FOCUS FIVE FUND

Dan went over a couple of his largest positions and his thinking behind them. These are compelling ideas, and I want to share them with you.

His largest position today is Outerwall (OUTR:nasdaq). The company is most famous for its legacy coin-counting kiosks. They also have the Redbox DVD kiosks. Beyond these two businesses, Coinstar is creating new complementary products and services.

"For example," Dan says, "on the coins, they've introduced a new program where you can drop a jar of coins into a machine and, instead of paying 8% to collect cash at the register, you can upload your dollars to your PayPal account. This saves on commission and allows you to easily transfer those funds." Western Union, by way of comparison, is much more expensive.

On the Redbox side, Coinstar is selling sporting event and concert tickets at the kiosks. It is also launching a service with Verizon called Redbox Instant. You pay $8 a month to receive unlimited movies at home. Included as part of that, you get four DVD kiosk rentals per month. These are new releases, which you wouldn't get with Netflix. "We think it will play well with existing kiosk users," Dan says. "If you are already paying $1 at the kiosk for a DVD rental, what's paying $4 to get unlimited content at home?"

There are also new ventures. Rubi is a joint venture with Starbucks and provides coffee in venues where you wouldn't find a full-service Starbucks. There are a whole bunch of other ventures Coinstar is launching. The company is even changing its name to Outerwall.

Dan goes through some of the numbers for the stock, which was $59 when we talked:

> The stock trades for about 4 times cash flow, and about half the float is short. [Ed. Note: This means many investors have bet against it.] The stock has about a 6% weighting in the fund. Our average cost is about $50. So we've earned some money, and I'm still adding to it. We think it is probably worth $75–80, conservatively. That's a 5 multiple on the coin business and a 4 multiple on the DVD business. We also give them some value for Rubi and other stuff — about $100 million.

There is a catalyst. The company has a convertible bond, which creates a natural reason for the shorts. People buy the bond (which converts to stock) and short the stock — creating a position where they earn interest on the bond and take no risk on the stock. Coinstar recently raised $300 million of low-cost debt. (It didn't have any debt, which is important, Dan says, because they can leverage up even more.) "They are going to use that to buy back the convertible bond," Dan said. "And so that's a potential catalyst in the next several months. As shorts cover (or buy back the stock they sold short), the stock should start to work."

There is also a short thesis that says the DVDs are not just in perpetual decline, but that a sharp decline is going to happen very soon.

"I don't think that is the case," Dan says. "An iTunes rental at $6 is not as attractive as a Redbox rental at a $1. I think their business will survive, and in the meantime, it's generating substantial amounts of cash."

Dan also likes the CEO, who has been in the job for several months. "He came from Microsoft. We think he has a sensible game plan."

Idea No. 2, and the second largest in the fund, is General Motors. Yes, GM.

"It is a 5% position," Dan says. "Our average cost is $28.50. The stock is $33. We think it is worth low- to mid-$40s looking out 12–15 months. It has gone through a major restructuring, as you know."

As part of that restructuring, GM has totally revamped its pension and health care liabilities. The unions have significant ownership of the stock. "Today, GM is very healthy," Dan says. "The balance sheet is overcapitalized. And depending on how you want to look at it, they have net cash on the balance sheet."

The government is also an owner. It has just sold some stock, timed with the addition of GM to the S&P 500 index. The government will continue to be a seller. "We think they will be out by end of the year," Dan says. But there is more.

Once the government stake falls below 10%, GM can pay a dividend. This will qualify the stock for all those dividend-paying mutual funds out there. "And then we think GM will probably buy back stock," Dan says. This is another catalyst for the stock.

Beyond the financial stuff, the business itself is doing well.

"I think they are doing a terrific job managing the business," Dan says. "In China, they are No. 1 today. They have been investing in luxury vehicles and have done extremely well. Europe is probably at a bottom today. They've been investing in clean tech and hybrids, and we think their line of pickup trucks will do especially well as housing recovers."

So there are two ideas from Dan. You can be sure that whatever he owns, he has super-high conviction in the idea. Remember what Dan told us last summer: "My philosophy on this fund is very simple. If I don't have to own it, if I don't feel compelled to own it, then I don't own it. I can do that running a very concentrated fund. I don't want to mimic the market. I want to beat the market."

I fully expect he will.

IMPORTANT INFORMATION

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Effective January 1, 2012, the Fund changed its name and investment strategy from "The Gabelli Woodland Small Cap Value Fund" to "The Gabelli Focus Five Fund". Through June 30, 2013, 33.41%, 9.93%, 10.10% and 9.61% are the one year, the five year, the ten year, and life of Fund (12/31/02) average annual returns for The Gabelli Focus Five Fund Class I Shares (GWSIX). Gabelli Funds, LLC, the Advisor reimbursed certain expenses to limit the expense ratio during the period from inception. Had such a limitation not been in place, returns would have been lower. The most recent Gabelli Focus Five Fund prospectus, dated Jan. 28, 2013, shows the total annual fund operating expenses after fee waiver and/or expense reimbursements as 1.46% for Class I shares. The gross expense ratio in the January 28,2013 is 2.16% for the Class I shares. As of June 30, 2013 the expense ratio has decreased to approximately 1.20% due to an increased asset base. There is no guarantee that assets will continue to grow or remain the same and any reduction in asset size generally would lead to an increased expense ratio. Assets and expenses in the Fund may fluctuate which will impact the expense ratio either positively or negatively. The Advisor has contractually agreed to waive its investment advisory fee and/or to reimburse expenses of the Fund to the extent necessary in ordert to limit the Fund's expense ratio at 1.45% for Class I Shares. This arrangement is in effect at least through January 31, 2014. The Fund imposes a 2% redemption fee on shares sold or exchanged in seven days or less after the date of purchase.

Total returns and average annual returns are historical and reflect changes in share price, reinvested dividends and capital gains and are net of expenses. Performance pertains to Class I shares only. Other share classes may have different performance characteristics. Class I Shares are available solely to certain institutions, directly through G.distributors, the Fund's Distributor or brokers that have entered into selling agreements specifically with respect to Class I Shares. Past performance of stocks highlighted in The Focus Five (published quarterly from January 2006 through November 2011), a research report published by G.research, does not represent historical performance of and is not indicative of the performance of The Gabelli Focus Five Fund. The investment strategy of the Fund is different than the stock selection process of the research report. Dan Miller is a member of the portfolio management team for The Gabelli Focus Five Fund. Individual securities mentioned are not representative of the entire portfolio. The views expressed in this article reflect those of the Portfolio Manager only and all performance information is through June 30, 2013. The Portfolio Manager's views are subject to change at any time based on market and other conditions. As of June 30, 2013, The Gabelli Focus Five Fund held the following as a percentage of its net asset value: Outerwall 5.9%; General Motors 4.9%.

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