Conviction Pays Off For Gabelli's Fast-Growing Focus Five Fund

By Steve Schaefer Forbes Staff

While an undergrad at the University of Miami, Dan Miller served as the student representative to the school's board of trustees. That role put him into contact with billionaire Mario Gabelli, whose investment firm managed a piece of the university endowment.

Fast forward a few short years, the young man who attended stock camp at the Breakers hotel in Palm Beach as a kid, is managing a rapidly-growing mutual fund for Gabelli's investment firm, the Gabelli Focus Five Fund (GWSVX).

The premise of the fund – a collection of "best ideas" with up to 50% of assets in the top five positions – has its roots in a report the firm began publishing in 2006, helmed by Miller, which canvassed analysts and fund managers for their highest-conviction ideas.

Today, using a similar universe of picks, Miller runs a fund with a mandate that allows to put as much as 50% of his portfolio in his top five ideas, though he has yet to push anything to that level just yet.

The strategy has swelled to more than $125 million under management, up from just $5 million when it was launched by taking over a small-cap strategy that had failed to gain much traction.

Miller's four-step investment process is straightforward, but one he follows strictly: he has to be interested in owning the company outright; he has to have a direct and open line of communication with management; the stock must be trading at a 30-50% discount to intrinsic value; and it must be the subject of a catalyst within three to 18 months.

Those requirements help narrow the fund's focus, but just as important, Miller says, is the discipline to avoid the pitfall for a lot of portfolio managers: dabbling.

"They attend a conference, see an idea in Forbes or Barron's, and buy some," he explains. Before long the fund has several hundred positions, which makes it difficult to have real conviction in each holding.

Of course, that high conviction doesn't mean you ignore when things change and stay married to those positions.

"I don't fall in love," he says, flashing an unadorned ring finger, and that carries over to his investment strategy.

Last April, when Barnes & Noble secured a $300 million investment in its Nook business from Microsoft, he immediately sold his position in the bookseller, even though it wasn't exactly the catalyst he was counting on.

Miller thought a bidder from the online space (Google or Amazon perhaps) might have interest in Barnes & Noble's retail operation as a physical venue to push content onto their tablets, but once Microsoft cut the Nook deal he wasted no time, selling his position before the market opened on the day of the press release trumpeting the joint venture.

(Barnes & Noble was back in the headlines Monday, on news that founder and Chairman Leonard Riggio is renewing his effort to take the business, or at least its retail side, private. Click here for coverage from Forbes' Abe Brown.)

Now, with assets swelling, Miller's biggest challenge is not finding ideas he believes in, it's putting money to work.

Holding cash, Miller says, was the single biggest detractor to his performance in 2012. Some of that is psychology — days when the market is up and investors are putting money into equity mutual funds are not the best days for those funds to be buying stocks.

"We don't feel the need to be fully invested every day, he explains. "Our focus is earning a return on an absolute basis over a multi-year period.

In that vein, Miller tries to be opportunistic, but with cash flowing in he finds himself buying whichever of his core ideas looks the best on any particular day.

Among those positions: RealD, which makes devices for movie theaters that make 2D projectors capable of 3D screenings. The company doesn't charge theaters for its system, which costs about $10,000, but in return it gets lengthy contracts for a percentage of gross ticket sales, a recurring revenue model Miller finds attractive. RealD also has a strong competitive advantage, with about 80% of U.S. 3D screens.

Miller thinks the stock, which goes for $11.60 as of Monday morning is worth at least $20 a share and is a possible takeover candidate. He bought aggressively during the fourth quarter when the stock sank as low as $8.80, but even so the weighting in the portfolio has declined from 9% to 5% due to the flood of new assets.

In the fourth quarter, the fund opened a position in Coinstar. Miller thinks the staying power of the company's Redbox unit, a DVD rental kiosk operation that recently launched a streaming video joint venture with Verizon aimed squarely at Netflix, is substantially undervalued by the market. Throw in the slow-growing but cash-throwing coin counting business and other development projects the company is working on and he sees a private market value of $73, compared with the stock's current $53.25 level.

Coinstar is currently the largest holding in Miller's portfolio at 7.5%, followed by nutritional supplement retailer GNC Holdings (7%), oil and gas equipment and services provider Weatherford International (5%), Internet connectivity company InterNAP Network Services (5%) and RealD (5%).

Miller, who managed a net gain of 26.2% without owning some of the year's best-performing stocks like banks, home builders and Apple, is focused on value, but also mindful that fat yields can be deceiving.

Hockey great Wayne Gretzky used to say he wouldn't skate to where the puck was, he'd skate to where it was going to be. In much the same way, Miller ignored the fat yields in sectors like utilities last year in favor of a play that doesn't currently pay shareholders.

"Some dividend stocks have gotten inflated," he says, "because people just want the check every quarter."

CIT Group, the once-bankrupt lender to small and medium-sized businesses, has $2.5 billion in capital and Miller think it is a matter of when, not if, the company will get the green light to return some of that to shareholders, either through a dividend or share repurchase .

"We're not just buying good or cheap companies," Miller says. "We're buying great companies where we understand the CEO's vision and see a catalyst."

That strategy paid off in the fund's strong 2012 debut, and its first full year is off to a similar start, up 6.5% through Feb. 21 versus a 5.7% return for the S&P 500.

IMPORTANT INFORMATION

Returns represent past performance and do not guarantee future results. Current performance maybe lower or higher than the performance data quoted. 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 December 31, 2012, 26.20%, 4.95%, and 8.49% are the one year, the five year, and life of Fund (12/31/02) average annual returns for The Gabelli Focus Five Fund Class AAA shares (GWSVX). The current expense ratio after reimbursement from Advisor for The Gabelli Focus Five Fund Class AAA shares is 1.71%. The gross expense ratio is 2.41%. 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 Fund imposes a 2% redemption fee on shares sold or exchanged in seven days or less after the date of purchase. The S&P 500 Index is an unmanaged indicator of stock market performance and is adjusted for reinvestment of dividends. You cannot invest directly in an index.

Total returns and average annual returns are historical and reflect changes in share price, reinvested dividends and capital gains and are net of expenses. Investment return and principal value will fluctuate so, upon redemption, shares may be worth more or less than their original cost. Stocks are subject to market, economic and business risks that cause their prices to fluctuate. Consequently, you can lose money by investing in the Fund. Performance pertains to Class AAA shares only. Other share classes may have different performance characteristics. Past performance of Gabelli & Company, Inc.'s research report, The Focus Five (published quarterly from January 2006 through November 2011), is not affiliated with The Gabelli Focus Five Fund. The investment strategy of the Fund is different than the stock selection process of the research report. To obtain the most recent month-end performance information and a prospectus, please call 800-GABELLI or visit www.gabelli.com.

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 through February 25, 2013. The Portfolio Manager's views are subject to change at any time based on market and other conditions. As of December 31, 2012, The Gabelli Focus Five Fund held the following as a percentage of its net asset value: GNC Holdings 8.4%; RealD 6.8%; InterNAP Network Services 5.4%; Weatherford International 5.1%; CIT Group 4.8%; Coinstar 3.5%. The Fund did not hold positions as of December 31, 2012 in other companies mentioned.

The Fund is classified as a "non-diversified" mutual fund, which means that a greater proportion of its assets may be invested in the securities of a single issuer than a "diversified" mutual fund. As a non-diversified mutual fund, more of the Fund's assets may be focused in the common stocks of a small number of issuers, which may make the value of the Fund's shares more sensitive to changes in the market value of a single issuer or industry than shares of a diversified mutual fund.

Investors should consider the investment objectives, risks, sales charges and expense of the fund carefully before investing. The prospectus contains more information on this and other matters. Please read the prospectus carefully before investing.

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