Gabelli & Company, Inc.
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Growth:

The Cycle is Turning....

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Large-Cap Growth-Rosy Scenario

The old saying, "what goes around, comes around" seems suited to a timely review of investing styles. After all, there is a cyclical nature to investment returns by style that is well documented and accepted by the investment profession. Over the past ten years we have experienced it first hand, as investors' late nineties love affair with large-cap growth stocks wilted, to put it politely. A romance with stocks suggestive of value and smaller-cap then blossomed. Now, after spending most of the last five years in purgatory, we believe large-cap growth stocks are in the early stages of returning to favor. We say this because the duration and magnitude of Growth's underperformance has been considerable and growth stock valuations have compressed. Additionally, the relative earnings outlook for growth stocks is positive and growth shares have already begun to outperform. Understanding the folly of trying to time such market rotations perfectly, we think this is a good time for investors to initiate commitments or increase their allocation to large-cap growth stocks.

Valuation Support + Strong Relative Earnings Growth = Style Out-performance

According to Russell/Mellon, earnings for the Russell 1000 Growth Index compounded at 15.4% over the past 5 years (ended 9/30/05). This trumped the earnings growth of the S&P 500 Index, which advanced earnings from $56.34 per share in 2000 to an estimated $74.44 in 2005, which equates to a compound rate of 5.7%. But growth stocks did poorly during the 5 years because their starting valuations were too high. As a group they declined in absolute terms for the first 2 years, before beginning to recover 3 years ago. As mentioned, many remain below their price of 5 years ago. To outperform, they typically need strong relative earnings growth and a reasonable valuation. This combination has been missing. Since the market low in 2002, the S&P 500 has experienced earnings growth every bit as good as growth stocks. The S&P 500 earned $48.13 in 2002. It should earn around $74.44 in 2005, making for a compound growth rate of 15.6% over the 3 years since the bear market ended. Growth stocks did no better than this. They did 15.5% (Russell 100 Growth Index data). In other words, since growth stocks' valuations hit bottom, their collective earnings growth has been no better than average.

Long-term, 15% is arguably the standard earnings growth bogey for diversified large-cap growth portfolios. This may change at some point but seems about right today. The earnings growth for the market slowed a bit in 2005 with a more dramatic slowing estimated for 2006. The rate of growth in 2005 over 2004 is estimated at 11%. The rate of growth projected for 2006 is currently 7%. Meanwhile, growth stocks are expected to make their 15% number, or close to it. Using the Russell/Mellon data, the consensus long-term earnings growth rate for the Russell 1000 Growth Index is 14.6%. Russell/Mellon calculates the Gabelli Growth Fund's current holdings should grow earnings at 15.1%. No doubt these estimates will be less than perfect. The point is we expect a widening gap between the market's earnings growth rate and the growth rate of quality growth stocks. Strong relative earnings growth is usually, but not always, good for growth stocks. Based on growth's out-performance over the past 2 quarters, we believe the tide is already turning (see table 1).

Table 1 The Tide is Turning - Growth Back on Top

The Large Caps	% 3 mos. 6/30/05	% 3 mos. 9/30/05	% 6 mos. 9/30/05	Market Segment
The Gabelli Growth Fund	2.3	6.7	9.2	Large-Cap Growth
Russell 1000 Growth	2.5	4.0	6.2	Large-Cap Growth
Russell 1000	2.1	4.0	6.1	Large-Cap Blend
Russell 1000 Value	1.7	3.9	6.0	Large-Cap Value
S&P 500	1.4	3.6	5.0	Large-Cap Blend
The Small Caps				
Russell 2000 Growth	3.5	6.3	10.0	Small-Cap Growth
Russell 2000	4.3	4.7	9.3	Small-Cap Blend
Russell 2000 Value	5.1	3.1	8.4	Small-Cap Value

Source: Gabelli.com, Russell.com and Bloomberg

Table 2 The Roaring Nineties - Large-Cap Growth Leads

	5 Years Ended 03/31/00 (annualized) %	Sector
The Gabelli Growth Fund	34.2	Large-Cap Growth
Russell 1000 Growth	31.7	Large-Cap Growth
S&P 500	26.7	Large-Cap Blend
Russell 1000	26.7	Large-Cap Blend
Russell 1000 Value	20.9	Large-Cap Value
Russell 2000 Growth	19.8	Small-Cap Growth
Russell 2000	17.3	Small-Cap Blend
Russell 2000 Value	13.2	Small-Cap Value

Source: Gabelli.com, Russell.com and Bloomberg

Gabelli Growth Fund, Class AAA - Average Annual Returns through December 31, 2005 1 Year 10.30%; 5 Year (5.28)%; 10 Year 8.22%. ***Past performance is no guarantee of future results.*** *Total return and average annual returns are historical and reflect changes in share price, reinvestment of dividends and capital gains and are net of expenses. The Gabelli Growth Fund performance is for Class AAA Shares. Other share classes may have different performance characteristics. To obtain the most recent month-end performance information for The Gabelli Growth Fund, please call 800-GABELLI or visit www.gabelli.com/funds. Due to market volatility, current performance may be lower or higher than the figures shown. Investment return and principal value will fluctuate so, upon redemption, shares may be worth more or less than their original cost.*

Investors should consider the investment objectives, risks and charges and expenses of the Fund carefully before investing. The prospectus contains more information about this and other matters and should be read carefully before investing.

The Roaring Nineties- Extraordinary Returns

Many of you remember the roaring nineties, especially the last half of the decade. Large-cap growth stocks were all the rage. For the 5 years ended 3/31/00 (the market peaked that March), the Gabelli Growth Fund returned 34.2% per annum, 750 basis points per annum greater than the 26.7% return earned by the Standard and Poor's 500 Index. The Fund outperformed the Russell 2000 Value Index of small-cap stocks by 2,100 basis points, on average, over the 5 years. (See table 2).

The market then declined for about 2.5 years and hit bottom on October 9, 2002. (See table 3). This was a painful period for us as we under-performed a declining market, especially during 2002. You will recall during this time the market was absorbing the bursting of the Internet bubble, followed by 9/11, a recession, unprecedented corporate scandals and the wars in Afghanistan and Iraq. It was the second longest bear market in history for the S&P 500 Index, having lasted about 921 days. As table 3 shows, large-cap growth stocks were hammered. Surprisingly, given the carnage elsewhere, small-cap value stocks, as measured by the Russell 2000 Value Index, eked out a positive return.

Table 3 **The Collapse (3/24/00 - 10/09/02)**

2.5 Years Ended 10/09/02 (annualized)

	%	Sector
Russell 2000 Value	0.6	Small-Cap Value
Russell 1000 Value	-11.9	Large-Cap Value
Russell 2000	-18.7	Small-Cap Blend
S&P 500	-22.3	Large-Cap Blend
Russell 1000	-22.5	Large-Cap Blend
The Gabelli Growth Fund	-32.7	Large-Cap Growth
Russell 1000 Growth	-32.7	Large-Cap Growth
Russell 2000 Growth	-34.2	Small-Cap Growth

Source: Gabelli.com, Russell.com and Bloomberg

Table 4 **The Rebound (10/9/02 - 11/30/05)**

3.15 Years Ended 11/30/05 (annualized)

	%	Sector
Russell 2000 Value	26.5	Small-Cap Value
Russell 2000	26.0	Small-Cap Blend
Russell 2000 Growth	25.4	Small-Cap Growth
Russell 1000 Value	21.3	Large-Cap Value
The Gabelli Growth Fund	18.8	Large-Cap Growth
Russell 1000	18.5	Large-Cap Blend
S&P 500	17.7	Large-Cap Blend
Russell 1000 Growth	15.5	Large-Cap Growth

Source: Gabelli.com, Russell.com and Bloomberg

The market has worked its way higher in erratic fashion in the 3 years since October 9, 2002, led by the small-caps. (See table 4). Among the large-caps, the Gabelli Growth Fund lagged the Russell 1000 Value Index, but outperformed the Russell 1000, S&P 500 and Russell 1000 Growth indices during this rebound phase. This is consistent with our historical tendency to do comparatively better in rising markets than in falling ones. Incidentally, our decision in the aftermath of the bear market to hold a more diversified portfolio with greater sensitivity to benchmark risk has reduced our stock specific and sector specific levels of risk. We believe this has enhanced your risk adjusted return potential and should improve our relative performance in a declining market.

Large vs. Small

Returns over the most recent 5 years (ended 11/30/05) vary greatly by market segment. (See table 5). The S&P 500's nearly static return of 0.6% compounded annually is misleading and does not tell the whole story. Using the Russell indices to segment the market shows the degree to which large-caps lagged small-caps and growth lagged value. Looking just at the market cap bias, large-caps as defined by the Russell 1000 Index (includes growth and value), returned 0.9%, not much better than the S&P 500's 0.6% return, which makes sense, since the S&P is predominately a large-cap index. Small-caps, however, defined by the Russell 2000 Index (includes growth and value), returned 9.7% per annum over the 5 years, beating the large-cap Russell 1000 by 880 basis points, on average, per year. The small-cap advantage was significant and becomes greater when small-cap growth stocks are excluded from the universe.

Remember, this has been cyclical. The 5 years ended March 31, 2000 were the opposite, with large-caps outperforming small-caps by a wide margin. Specifically, the small-cap Russell 2000 compounded at 17.3% per annum, while the large-cap Russell 1000 returned 26.7% annually, beating the small-caps by 940 basis points on average. The mostly large-cap S&P returned 26.7% annually.

Table 5 **The Small-Cap and Value Era**

5 Years Ended 11/30/05 (annualized)

	%	Sector
Russell 2000 Value	15.8	Small-Cap Value
Russell 2000	9.7	Small-Cap Blend
Russell 1000 Value	6.0	Large-Cap Value
Russell 2000 Growth	2.9	Small-Cap Growth
Russell 1000	0.9	Large-Cap Blend
S&P 500	0.6	Large-Cap Blend
Russell 1000 Growth	-4.8	Large-Cap Growth
The Gabelli Growth Fund	-5.2	Large-Cap Growth

Source: Gabelli.com, Russell.com and Bloomberg

Table 6 **Higher Earnings, Lower Stock Prices**

Security	3/30/00 Price ($)	11/30/05 Price ($)	% Change	2000 EPS ($)	2005 EPS ($)*	% Change
GE	52	36	-31	1.27	1.72	+35.4
Microsoft	48	28	-42	0.93	1.32	+41.9
Home Depot	65	42	-35	1.10	2.67	+142.7
Wal-Mart	57	49	-14	1.40	2.64	+88.6
Costco	53	50	-6	1.29	2.29	+77.5
Dell	54	30	-44	0.84	1.55	+84.5
Yahoo	86	40	-53	0.24	0.60	+150.0
Texas Instruments	80	32	-60	1.22	1.39	+13.9
Linear Technology	55	37	-33	1.29	1.45	+12.4
Tiffany	42	41	-2	1.26	1.65	+31.0

* Forecast

Source: Baseline

Growth vs. Value

Next let's compare large-cap growth against large-cap value, for the most recent 5 years, using the Russell 1000 Growth and Russell 1000 Value indices as proxies. (See table 5). In this case, the Growth Index returned –4.8% annually while the Value Index gained 6.0% annually. Large-cap growth did worse than the S&P's return of 0.6% and a whopping 1,080 basis points worse than large cap-value, compounded over 5 years. Again, the experience in the preceding 5 years, ended March 31, 2000, was entirely different.

During this period, growth led the way, as the Russell 1000 Growth Index gained 31.7% per annum and the Russell 1000 Value Index returned 20.9% annually. In this case, the annualized advantage for growth was 1,080 basis points. This was the period during which the Gabelli Growth Fund returned 34.2% annually and the S&P returned 26.7%.

The biggest divergence in the most recent 5 years has been between small-cap value and large-cap growth. Here, the small-cap Russell 2000 Value returned 15.8% annually, while the large-cap Russell 1000 Growth lost 4.8% annually. This gives rise to a performance gap of 2,060 basis points in favor of small-cap value. Once again, the 5 years ended March 31, 2000 were the polar opposite, with the Russell 1000 Growth gaining 31.7% annually, compared to 13.2% for the Russell 2000 Value Index. This resulted in a performance gap favoring large-cap growth in the amount of 1,850 basis points compounded.

Feeling Like Rodney Dangerfield

An examination of the September 30, 2005 Lipper mutual fund data lends additional color to the sector rotation debate. According to Lipper, growth accounts for about one-quarter of the large-cap mutual fund universe, measured by assets under management. Additionally, large-cap represents no more than one-third of the growth mutual fund universe. I suppose it is possible for growth to continue to shrink and represent less than one-quarter of the large-cap fund base and large-cap growth could shrivel to less than one-third of the growth universe, but I think it is unlikely. Large-cap growth is so neglected that the two largest active fund managers, Fidelity Investments and American Funds, don't have one mutual fund between them classified as large cap-growth by Lipper on September 30, 2005. Like Rodney Dangerfield, large-cap growth can't get any respect.

While a number of large-cap growth stocks have done well over the past 5 years, you don't have to look far to find some high quality names whose stock prices are lower than they were 5 years ago, despite recording higher earnings. (See table 6). For example, GE's earnings are 35% higher than in 2000, yet the company's share price is 31% lower. Microsoft's earnings are 42% higher, yet the stock is 42% lower. Home Depot's earnings are 143% higher, while the stock is 35% lower. Dell Computer's earnings have risen by 85%, and the stock is 44% lower. Other examples of higher earnings and lower stock prices include Wal-Mart, Costco, Yahoo, Texas Instruments, Linear Technology and Tiffany. We currently own shares in all of these companies.

The price/earnings multiple compression for large cap growth stocks has been significant. Using the Russell 1000 Growth Index as our proxy, and enlisting the help of Ned Davis Research, we find that the P/E for the Growth Index at the 2000 peak was about 50 times trailing earnings. At the same time, the P/E for the Russell 1000 Value Index was about 20 times. Therefore Growth stocks sold at about a 150% relative premium to value stocks. Today, the Growth Index is selling at 21.7 times trailing earnings and the Value Index at 14.3 times trailing earnings, leaving a growth premium of about 52%. According to Ned Davis Research, the 27-year average growth premium is 58%. Large cap growth stocks are much cheaper than 5 years ago, in absolute and relative terms, and are priced below their average premium to value stocks (over the past 27 years). We believe the premium valuation accorded growth shares stands a good chance of expanding unless long-term interest rates move materially higher, because their companies' relative earnings growth prospects are stronger than in recent years.

The truly high horsepower performance for growth stocks occurs when you combine strong earnings growth with price/earnings multiple expansion. This is what happened in the nineties. In such an environment the stocks appreciate at a faster rate than the growth in earnings. We can't count on this as long as interest rates are rising and oil prices are pinching earnings. Actually, we can't count on it even if interest rates fall and oil prices collapse. In such an environment the more cyclically positioned companies are likely to see their stocks do relatively well. Trying to be too cute in predicting stock market outcomes is dangerous. Our message is simple and doesn't depend on multiples expanding. There is a cyclical nature to investment returns by style. After 5 years of underperformance, we believe there is enough evidence to argue in favor of growth stocks at this time. For the last 2 quarters, large-cap growth has outperformed large-cap value and small-cap growth has outperformed small-cap value (See table 1). We believe the cycle is turning.

The S&P 500 Index is an unmanaged indicator of stock market performance and is adjusted for reinvestment of dividends. The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index. The Russell 3000 Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization. The Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000 Index. The Russell 2000 Value Index measures the performance of those Russell 2000 companies with lower price-to-book ratios and lower forecasted growth values. The Russell 2000 Growth Index measures the performance of those Russell 2000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. The Russell 1000 Growth Index measures the performance of those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values.

Note: The Gabelli Growth Fund is changing its name to The GAMCO Growth Fund. Similarly, Gabelli Asset Management Co. is now GAMCO Investors, Inc.

For more information, visit our website at:

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