Reprint

CAPITAL & CRISIS

July 2012 NUMBER 101

How to Get a Seat in "Gabelli's Kitchen"

Mutual funds are too often just a kind of financial junk food. Investors get a quick and easy portfolio, habitually stuffed with hundreds of stocks. No wonder their returns are frequently poor.

But there are exceptions.

The folks at Gabelli & Co., led by the stock picking gourmand Mario Gabelli, have cooked up a profitable recipe for serving quality ideas. From January 2006 to the end of 2011, these ideas have returned 210%, versus a negative 5% return for the market overall. There is now a surprisingly easy way to get yourself a seat in Gabelli's exclusive kitchen.

Meet Dan Miller. I've known Dan since 2006. He's been managing Gabelli & Co.'s research business for about eight years now. Six years ago, Gabelli's research team started publishing the Focus Five report. It revealed just their five best ideas, updated every quarter. Sometimes names would carry over. Sometimes not.

"We decided to start publishing this report to draw attention to the quality of our ideas," Dan said. "We thought we had a unique fundamental process where we would estimate a company's private market value." Private market value is what an acquirer would pay to buy the whole business. Wide gaps between stock market value and private market value are what attract team Gabelli.

"We also identify a catalyst," Dan adds. "Not just a catalyst, but a near-term event, which to us meant between three and 12 months." And perhaps most importantly: "We have to speak to management and trust them. We have to understand how they are going to create value for shareholders."

As mentioned, this recipe has delivered excellent results. "The Focus Five report showcased a truly superior research process and team, and our ability to find really good ideas. Our picks as a whole were up even in 2008, for example," Dan noted.

Over time, the Focus Five report got a lot of attention. "We would get phone calls from people asking how they could get a copy of the report," Dan remembers, "and they would sometimes ask for a fund that did this." So Dan convinced Mario to turn the idea into a fund. They converted a tiny small-cap fund that Dan took over in January. The Gabelli Focus Five Fund was born.

"For IRS purposes," Dan continued, "we can't have just five investments. So the fund will have anywhere from 25–35 investments, but up to half of the fund could be in just five investments — if we have a high level of conviction. Today, the top five names are about 35% of the fund. It's really a concentrated, high-conviction, best ideas strategy."

So importantly, the fund is not the report. But the Focus Five Fund grew out of the same process. "We've got 35 analysts that cover various industries," Dan says. "In addition, we've got about a dozen portfolio managers with certain specialties. We all convene every day at 8 a.m. in a firmwide morning meeting. We have a fluid flow of info about ideas. My job is to look at these ideas and determine the high-conviction names. Mario is our best analyst, for example. I talk to him every day. And I can tell you when he likes a stock and when he loves it… and when he really loves it."

Unlike the report, Dan is not beholden to the turn of the calendar marking a new quarter. He has no problem holding an idea for a year or two or longer. "But I'm not buying it and waiting three years for something to happen," he says. "I have to have a near-term event."

As an example, Dan started buying Barnes & Noble in mid-March at $13.50. He bought all the way down to $11.50. "I had very high conviction in the valuation," Dan said. "We thought, at that price, we were paying zero, or less than zero, for the Nook business. And we liked the college bookstore, which is a cash cow."

In addition, insiders were intent on unlocking that value. In a matter of weeks, Microsoft decided to make an investment in the Nook business. "The stock was trading pre-market at $27 and I sold my entire position at $27.21," Dan remembers. "At that price, it was trading very close to our private market value estimate of $30. The stock traded down all day to $21, and today it's $17. I got lucky. But my point is that we have no problem taking short-term gains. Or losses, for that matter."

Dan talked about how he bought Ivanhoe Mines at $15 in January. He liked the business, the CEO and the valuation. By April at $12, he decided he got it wrong. "I have no problem admitting when I'm wrong," Dan said. "I don't need to sit in a stock for a year and then find out I was wrong."

When I talked to Dan, his fund was up about 6% for the year. He had a slow start in January and February because he held a lot of cash. In January, the fund averaged 40% in cash. He had money coming in and was selling the old fund's holdings. But that is behind him now. In the second quarter, he was down half what the market was down. Now he's fully invested in high-conviction ideas.

We got to talking about some of those high-conviction ideas.

"I just started buying Federal-Mogul (FDML:nasdaq) at $13.50. We know it well. We know the catalyst is Icahn doing something, like spinning off the aftermarket business. I also own Dana and Tenneco. I like all three."

"Auto parts suppliers, in general, seem like a place that ought to do well," I said. "The valuations are compelling."

"Yeah, these three companies make up about 13% of the fund. I think all of them have the potential to be doubles," Dan said. "My top position today is Brink's. That's a very interesting business."

Brink's (BCO) is in the business of ensuring the safe delivery of valuables. Markets outside of the U.S. account for more than 30% of sales and could grow by 50% by 2015. Brink's is already profitable in Brazil, Russia, India and China.

Trading around $23, and with a new CEO, Brink's trades for just 4 times Gabelli's 2012 EBITDA estimate of $365 million. (EBITDA is earnings before interest, taxes, depreciation and amortization. Think of it as a broad earnings measure.) On a sum-of-the-parts basis, Dan believes the shares are worth $45 per share.

Another interesting business is RealD (RLD). Dan takes us through it:

> RealD is a manufacturer of a 3-D projector device that goes on top of a 2-D projector. It has a very good business model. RealD manufactures these devices and it costs them about $10,000 each. They then give them to the theaters for free. But in exchange, RealD gets a 10-year contract whereby it collects 50 cents per 3-D ticket.

The U.S. market is close to saturated, but RealD continues to grow fast overseas. At some point soon, this will turn into a real cash cow. The catalyst is further growth in the 3-D movie market, which is being fueled by the major studios repurposing their old content.

"So for example," Dan says, "Lion King came out years ago, but Disney re-released it in 3-D. It cost them $5 million to convert it and they generated $100 million in ticket sales." Studios, then, have a big incentive to follow suit. And RealD gets 50 cents per ticket. The stock today is $11 and Dan thinks it is worth closer to $20 per share. "We think a logical buyer might be someone like Dolby," he added.

How about one more?

Dan told me about Rochester Medical (ROCM).

"They make catheters," Dan says. "They have very good technology. The management team is very smart and focused on shareholder value. There is a board member who is also the CEO of a competitor — Teleflex — and I think he's a buyer for the whole company. 3M has also started to nibble at Rochester's products and for the very first time had Rochester speak at one of their customer conferences. I think 3M could buy Rochester. The stock is about $10, but I think it's worth $18 in a transaction."

Rochester is the fund's fifth-largest position. "I have a very high level of conviction in their business. We speak to them all the time. We trust them. I could wake up any day now and find that we got taken out at $18 per share. That would be a 4% move in the fund. That's what we want to do here."

High conviction, big impact.

"My philosophy on this fund is very simple," Dan summed up. "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."

The Gabelli Focus Five Fund is a small fund, with about $11 million under management. It's just starting out, giving you a chance to get in practically on the ground floor. The ticker is GWSVX. I love the idea of the fund and Gabelli's approach. I think it will be a winner in the years ahead. It's a smart option if you are looking for something other than mass-produced pink slime served up by the big mutual fund houses.

We'll keep an eye on this fund and check back with Dan again in the future.

IMPORTANT INFORMATION

Capital & Crisis is published monthly by Agora Financial, LLC, 808 St. Paul Street, Baltimore, MD 21202-2406. Subscriptions are US $159 per year for U.S. residents. Minor edits have been made to this reprint.

The past performance noted does not guarantee future results. 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 March 31, 2012, the performance of the Fund under the new investment strategy was 9.96% year-to-date. Through March 31, 2012, -6.03%, 2.40%, and 7.95% 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 2.01%. The gross expense ratio is 2.80%. 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.

Total returns and average annual returns are historical and reflect changes in share price, reinvested dividends and capital gains and are net of expenses. 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. 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 May 22, 2012. The Portfolio Manager's views are subject to change at any time based on market and other conditions. As of March 31, 2012, The Gabelli Focus Five Fund held the following as a percentage of its net asset value: The Brink's Company 8.2%; Barnes & Noble 0.1%; Ivanhoe Mines 1.2%; RealD 2.1%; Rochester Medical 4.4%; Dana Holding Corp. 3.5%. The Fund did not hold positions as of March 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.

For more information or a prospectus, visit our website at: www.gabelli.com or call: 800-GABELLI
800-422-3554 • 914-921-5100 • Fax: 914-921-5118 • info@gabelli.com
Distributed by G.distributors, LLC, One Corporate Center, Rye, New York 10580