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What should investors focus on? (Hint: It's not the economy.)

by Chris Mayer

The "fiscal cliff" drama may be over, but many investors still wonder how the new deal will affect the economy — and their investments.

Here's a bit of advice to begin 2013: Ignore economic forecasts when it comes to investing in the stock market.

That might sound outrageous, since the subject seems to dominate the discussion, especially this year with all the fiscal cliff chatter. But the economy is not the stock market. You can have a lousy economy and a great stock market. And you can have a great economy and lousy stock market.

Take Greece, for example.

In 2012, the Greek market was among the best-performing in the world — up 33 percent. Yes, that Greece. The one you saw on TV with protesters in the streets with the molotov cocktails and tear gas. The country with unemployment north of 25 percent, a shrinking economy and crushing debts. Yet Greek stocks more than doubled the return of U.S. stocks last year. Meanwhile, the Greek economic crisis is ongoing.

Greece is an extreme case — its stock market was rebounding from recent lows — so perhaps it was just a lucky break for investors.

But there are many other examples, across different markets and time periods, when economies and markets have gone separate ways.

Warren Buffett knows this. He once looked at gross domestic product, a commonly used measure of economic growth, and pointed out that from 1964 to 1982, the U.S. stock market went nowhere even though GDP quintupled. But from 1982 to 1998, the stock market rose 20-fold while GDP barely tripled.

There are lots of reasons to explain market moves. The economy isn't one of them. This is probably why the greatest investors aren't economists.

Peter Lynch is one of those investors. He made his name as the pilot of Fidelity's Magellan Fund from 1977 to 1990, where he racked up average returns of 29 percent a year. Lynch's take on all this is best summed up by a now-famous quote of his: "If you spend more than 13 minutes analyzing economic and market forecasts, you've wasted 10 minutes."

Yet, I can't tell you how many times I've spoken at investment conferences or given radio or TV interviews and had someone ask me about my economic forecast. Despite all the wisdom of the world's greatest investors, many people insist on spending most of their time trying to figure out unknowable things — like what the economy is going to do. Maybe it's not their fault, as the financial industry produces reams of this kind of stuff every year.

So, if trying to predict how the fiscal cliff will affect the economy is a waste of time, what should you focus on?

In a word: price.

The old saw on Wall Street is that good things happen to cheap stocks. In Greece, for example, you could have bought Metka, a Greek construction company. At the start of 2012, you would have paid less than four times trailing earnings per share. A comparable U.S. company might fetch four times that. The dividend yield was about 8 percent. This for a company with a 20-year history of turning a profit. Metka's stock rose 64 percent in 2012.

The basic principle here is the same one you use when you buy gasoline: You try to shop where you can get the most for your money. The stock market is no different. Although there are many other factors to consider, the price paid for what you get is a big one.

Just ask the investors who piled into Facebook's stock during its initial public offering. It's a great company, but was it worth $45 a share? At that price, the stock sold for more than 100 times trailing earnings. Sometimes stocks like that can work — but not often. Facebook's stock finished down 44 percent for the year.

What's cheap in the U.S. markets right now? Here's one example, but you won't like it: bank stocks.

Bank stocks had a good year in 2012. The KBW Bank Index, a decent proxy for bank stocks, rose about 30 percent in 2012. Despite this rise, bank stocks still offer good value today. One way to see this is to look at a bank's tangible book value per share.

This is a key industry measure, with many acquisitions priced off this statistic. In the past two decades, banks have been valued at about two to three times book at the high end of the cycle and about one times book at the low end. Right now, many good banks are trading below book value per share.

They're trading at those bargain prices because most people are sour on bank stocks. There are a ton of regulatory costs hitting the industry, which will hurt profitability. Banks also suffer from super-low interest rates, which crimp the profits they earn making loans. Moreover, competition is fierce.

(see back page for the rest of the article and Gabelli Focus Five)

Finally, we can't underestimate the lingering effects of the financial crisis, which burned investors in bank stocks.

All markets go in cycles, however. Someday, bank stocks will again trade for two times book value. (And when they do, you should sell them.) I'm not saying you should go out and buy bank stocks indiscriminately or that they will double overnight. I'm saying that banking is an area in the market where you can get a lot for your money.

I am also finding value in U.S. real estate. Residential housing is not the only real estate market that's been humbled in recent years. There are bargains in distressed hotels and shopping centers, too. Beyond real estate, there are always good businesses doing simple things that have fallen out of favor for one reason or another that you can buy cheaply.

Focusing on investments that will give you a lot for what you paid is an effective way to think about putting your money to work. It's much easier and more reliable than trying to guess what the economy might do.

You could assemble a fine portfolio of stocks that fit this basic principle. Or you could outsource that job to mutual funds.

One of my favorites is the Gabelli Focus Five Fund (GWSVX). It gained 26 percent in the year, easily topping the overall market's return. I interviewed portfolio manager Dan Miller in June and have spoken with him several times since. I find him a smart, enthusiastic stock picker focused on the right things. He isn't out there trying to figure out what's going to happen to the economy. He spends his time looking for great ideas.

Miller managed Gabelli's research team for eight years. The fund he now co-manages uses the same approach as Gabelli's celebrated Focus Five reports, which focused on the five best ideas from Gabelli's team of analysts. It racked up a 210 percent return from January 2006 to the end of 2011, when Gabelli stopped publishing the reports and turned the idea into fund. (The market lost 5 percent over that same time frame.)

To do this, Gabelli took an older small cap fund, renamed it and changed the portfolio to reflect the Focus Five strategy. Miller took the helm officially on Jan. 3 of last year. The fund is still small and as a result the expense ratio of 2 percent is high, but should fall as the fund grows.

Although the fund's strategy is not an exact replica of the Focus Five reports, it can put up to 50 percent of its assets into its five best ideas. Miller focuses on buying stocks at big discounts to what they would be worth to a private buyer, an approach I heartily endorse. As a result, the fund can enjoy significant windfalls when a buyout does occur. For example, TPG Capital bought Par Pharmaceutical for $50 per share a few months ago. The fund had 5 percent of its assets in the stock at an average cost of $34 per share. A big win.

This concentration could make the fund more volatile in the short-term. But with its focused approach on bargain stocks — not economic forecasting — the fund should continue to do well for its investors over time.

Mayer is founder and editor of Capital & Crisis, a value investment newsletter. He's the author of "World right side up: Investing across six continents."

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 December 1, 2012, the Fund's Class AAA shares returned 26.20%, 4.95% and 8.49% for the 1 year, 5 year, and since inception periods, respectively. The Fund's inception date was December 31, 2002. The Fund's Adviser has contractually agreed to waive and/or reimburse expenses to limit the Class AAA shares expenses at 1.70% on an annualized basis through January 31, 2014. 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. Class AAA Shares are no-load. Other share classes may have different load and expenses structures. 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. As of December 31, 2012, the Fund held no positions in any of the securities mentioned.*

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.

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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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800-422-3554 • 914-921-5100 • Fax: 914-921-5118 • info@gabelli.com
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