

Deep Value Surprises



Despite the market's run-up in 2003, Warren Spitz believes there are still opportunities to find value, and even "deep value" opportunities. Since he took over American Express' Diversified Equity Income portfolio three years ago, the fund has remained in Lipper's top quintile in the Equity Income category for the year-to-date, 1-year, and 3-year periods.

Q: What is the strategy behind the Diversified Equity Income portfolio?

A: The fund has two objectives - capital appreciation and income. That does a couple of things - it introduces income, which has a tendency to cushion your returns a little bit in down markets. Also, in certain environments it turns out to be a performance strategy. By that I mean that, over very long periods of time, dividend income and dividend yield turn out to be an important part of the total return. Since I have been here, I have exercised a style I describe as "deep value."

Before I started managing the fund three years ago, the general thrust was toward cheaper names on standard metrics. The bias was more towards larger cap stocks, and some growthier stocks. It maybe had been a deep value fund in the mid-1990s, but then it became more growth-oriented and looked more blend-like at the peak of the market than it should have been. My style is deep value, which means that we not only own stocks that are cheaper than core and growth portfolios, but also cheaper than other value portfolios.

As a general principle, we believe that you can't beat the competition by mimicking the competition. We take views that are not consensus. Thus we are constantly looking at stocks that have low ratings by Wall Street.

Q: You do not seem to have many restrictions apart from being at least 80% invested in dividend-bearing stocks. What other restrictions do you have?

A: There are a series of things related to income. If you are an equity income fund, you have to be 80% invested in income producing securities. It is also true in terms of policy that we want 65% of our assets to be invested in securities with above-market yield and that the overall portfolio on a gross basis at least should have an above-market yield, which means higher than the yield on the S&P 500. That is not by prospectus, though, that is by style. Otherwise, it is a pretty broad mandate.

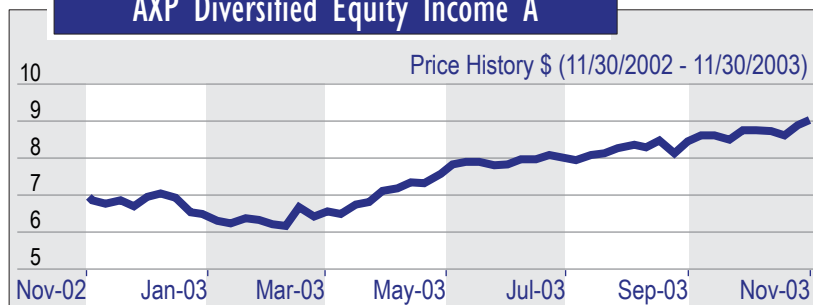
I should point out that there are no restrictions with regard to market capitalization. And that is an important element, because when I came three years ago, my argument was our shareholders would benefit if we got an exposure to the small-cap and mid-cap markets. And that has proven to be the case thus far.

Q: There are times in the market when value is more difficult to find, much less "deep value." Let's take this year, for instance, with the serious run-up in stock prices. How do you deal with such situations?

A: If you look at the recent activity in the portfolio, we have been looking at the energy and telecommunication services areas. These are the two areas that have lagged the market. Both areas have witnessed significant free cash flow generation and they have fairly high dividend yields. These are areas that we find attractive - the telecommunication services names more tactically, short-term, and the energy names more long-term. Yes, there is still value in this market.

AXP Diversified Equity Income A		
Fund Facts		
Symbol	INDZX	
Website	www.americanexpress.com	
Address	American Express Funds, 70100 AXP Financial Center, Minneapolis, MN 55474	
Tel. No.	800-328-8300	
Inception	10/15/90	
Portfolio		
Total Net Assets *	\$1,800	
Avg Mkt Cap (\$ Weighted) *	11,800	
Average Price/Earnings Ratio	---	
Average Price/Book Ratio	---	
Turnover Ratio	40%	
Investment Information		
New Investment	Open	
Min Initial Investment	\$2,000	
Min Subsequent Investment	\$100	
Min Initial IRA Investment	\$100	
Risk (Against S&P 500 - 3 Years)		
Alpha	0.8413	
Beta	0.9437	
R-Squared	0.8155	
Returns vs. Lipper Equity Income Index		
	INDZX	Index
1 Year (Cum.)	26.63%	14.20%
3 Year (Ann.)	4.81%	-0.44%
5 Year (Ann.)	3.96%	1.54%
Returns vs. S&P 500		
	INDZX	Index
1 Year (Cum.)	26.63%	15.09%
3 Year (Ann.)	4.81%	-5.52%
5 Year (Ann.)	3.96%	-0.47%
Fees and Expenses		
Max Sales Charge - Front	5.75%	
Max Sales Charge - Deferred	0.00%	
Max Redemption Fee	0.00%	
Total Expense Ratio	1.04%	
Portfolio Manager		
Warren Spitz	11/29/00	
* millions	Data through: 11/30/03	
Source: Company Documents; Lipper		

AXP Diversified Equity Income A



Q: Still, you are overweight in financials, which is the traditional value play.

A: Yes, we have a significant financial weighting. On the other hand, if you look at a common benchmark for value portfolios - the Russell 2000 Value index - the finance weighting there is much higher.

Q: Relative to the Russell 2000, you are more overweight in industrials, right?

A: That is absolutely true, and that is a key strategic thrust for us. Think of the industrials as somewhat synonymous with the cyclical stocks. Cyclical stocks underperformed consumer stocks in the Morgan Stanley indexes for 20 years in the 1980s and 1990s. Then, for two or three years they are essentially in a dead heat, and now the cyclical stocks have started to outperform.

We argue that many of these companies developed an ability to cut cost, manage process through Six Sigma, and manage disciplined capital spending, such that the outlook going forward is dramatically improved, depending on the precise industry you are looking at. In each case you have gone through a difficult period, in which demand was low. Now I think you are seeing a turn in the economy, and you have many of these companies with expenses screwed down so tightly that you are likely to see dramatic increases in margins. We think that this is an unrecognized secular shift in the markets. So, we have a weighting in industrials, which started to pay off for us in the last three months.

Q: Where, more specifically, are the turnaround stories in your largest holdings?

A: Caterpillar is a perfect example. This is a very well-run company that has also suf-

fered from some of the things I have already outlined, and one other issue I didn't mention - they are beneficiaries of a weaker dollar. A strong dollar created a problem in terms of competing globally for this company. For the most part, infrastructure-related companies and companies that service commodity-related businesses like Caterpillar had a very difficult time in the 1990s. But through the application of Six Sigma and intense cost control, they have positioned themselves for reasonable capacity in an economy that is growing and they also have a very tight cost control. I think people are going to be very surprised at the earnings power of this company demonstrated over the next couple of years.

True, it has moved up a lot. It certainly is not as inexpensive as it was six months ago or a year ago, but still we like Caterpillar. I believe at some point we will begin to think of this potentially as a growth stock. At that point we may not be a big holder anymore, but I think it can achieve above average growth in the next few years and attract a lot of attention.

Q: Tell me about your research. What kind of resources do you have at your disposal?

A: I work with a group - we call it the Deep Value Team. I am the portfolio manager, and we have two associate portfolio managers - Laton Spahr and Steve Schroll. We run some initial screens, looking for stocks that are inexpensive on standard measures, and then do additional fundamental research on the candidates that either fit within the theme, or are cheap on a number of measures, or both. We also have a research staff in Minneapolis that we use. They have done a lot of work on Caterpillar.

Q: And what makes a stock a "buy"?

A: It depends on the market sector. And the reason I say that is some of our holdings are considered more strategic. That is where we think there is what we call a semi-permanent shift, and where you need to be more concerned about fundamentals and the shift in the fundamentals and a little less concerned about the price. So, for example, we would like to hold on to Caterpillar, despite the fact that it has run up. There are other, more tactical areas, that we don't have a particularly favorable bias on, but they are statistically cheap. And I would put many of the financials in that area. For the most part, we think financials have seen their best days.

Q: That secular shift that you seek to identify, is it on a sector level, or on an individual company level?

A: It would be an industry, or in some cases, a sector. We do obviously invest in names that are one-offs in some fashion. Our second largest holding is Pacificare Health Systems, which doesn't fit some of these major themes. It is a managed-care organization that has a big Medicare business, which everyone had hated in the past. The company has done a very good job trying to transition from that business, and earnings have held up much better. This represents a shift that applies to a single company. Some of the other secular shifts I was talking about are really more industry-wide or sector-wide.

We have a very small weighting in the pharmaceuticals. I am concerned about the profit growth outlook and the political environment. I think this industry group, which has been very much backed and supported politically, has now become a target for a lot of criticism, in particular on their pricing. I think a lot of these companies will show earnings growth that is somewhat disappointing, and if you couple that with an economy that is rebounding, that is probably not an attractive combination. So, yes, they are cheap, but I am inclined to think that it is the wrong environment to be looking at this area.

Q: Does this explain to some extent your position in the energy sector? Because it definitely is supported politically.

A: I think our position in energy has more to do with supply and demand and the fact that energy prices are high and are likely to stay high. If you look at global oil, you are struck by the fact that BP and

Exxon-Mobil and many other companies are showing production declines. That suggests to me that there is not this excess of supply out there and energy prices are likely to stay higher longer. And if you assume that, it is pretty clear that the stocks are inexpensive on earnings.

seem to be that these businesses are going to evaporate in the next two or three years, then you wouldn't do that. I am not inclined to make that bet, so I think it is a reasonable place to be with a high dividend yield in the context of a market that has already run up 20%.

is no denying that they have been one of the best-performing areas in the market over the last three years. Unless you are really, really certain that there is a long-term future that favors this area, you have to think about reducing the weighting and that is what we have done.

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Q: Do you have some restriction on the number of holdings in your portfolio?

A: No, but as a practical matter, we won't exceed 100 by very much.

Q: When do you trim and sell a position?

A: Partly, we do it on a basis of valuation. If we buy a stock at 12 times earnings because we think it should be 15 times, as it approaches 14 or 14.5, we are going to start letting that position go. For the most part we are inclined to take profits, but that would be a hard decision in an area which would be a tactical purchase, like, again, telecommunications service stocks. We are not anticipating that we are going to be holding those for the next 50% gain. On the other hand, with Caterpillar, over a number of years, we might be looking for more than 50%.

Q: What exactly do you see then in telecom stocks - a price or a catalyst?

A: We belong to the group of investors that doesn't worry too much about catalysts. If a stock is cheap enough, sometimes the price is the catalyst. You had a dividend yield approaching 5% on some of these regional Bells, trading at less than 10 times free cash flow and that was virtually cheaper than any other segment in the market. So if you are really sure as some people

Warren Spitz

Warren joined American Express Financial Corporation in 2000 as a Senior Portfolio Manager for AXP Diversified Equity Income Fund, AXP Equity Value Fund, AXP Mid-Cap Value Fund, AXP Variable Portfolio/Diversified Equity Income Fund and IDS Life Series/Equity Income Portfolio. With 19 years of experience in the investment industry, Warren's asset management philosophy centers around deep value investing. Before joining American Express, Warren was a Portfolio Manager with Prudential Global Asset Management from 1987 to 2000 and a Senior Electric Utilities Analyst with Dean Witter Reynolds from 1985 to 1987. Before that, he worked in the equity research department at Value Line and was an underwriter with Travelers Insurance Company. Warren holds a B.S. degree from Allegheny College and an MBA degree from Wharton School at the University of Pennsylvania.

Q: Why don't you go for the dividend yield on REITs?

A: We are looking at areas that are contrarian in some fashion, and REITs don't quite fit the bill right now. They have been doing quite well for the past two or three years. It is not contrarian, because it has become a favorite way to stay in a market that scares a lot of people. I actually think REITs are reasonable places to be, but there

It is not that I am drawn toward more volatile stocks. I am just trying to build a portfolio of opportunities that can surprise people on the upside. In certain markets, a number of years ago, we had more REITs. But the REITs have moved up, and we really like to look in areas where the expectations are lowered in some fashion. When the expectations are low, it is relatively easy to beat them and stocks will do well. ■

Alexander Vantchev