

Between Growth and Value

Brad Brooks, the manager of Value Line Income and Growth fund, has to balance between growth & value, bonds & equities, and across all types of markets caps. A bit of contrarian approach and a lot of reading help him with the difficult task of covering almost the entire investing spectrum.

Q: What is the philosophy driving your investment decisions?

A: As the name suggests, the fund tries to provide balance between growth and income. It is diversified across different strategies and styles and in terms of market cap. Our holdings are divided approximately between 60% to 65% equity and 40% to 35% debt instruments.

Within the fixed income side, there is diversification between high-grade corporates, agencies, Treasuries, and a component of 5% of convertible debt. The equity part is also fairly balanced. My approach is to have some growth, usually at reasonable price, and some value, because it is difficult to predict which style will outperform over the next few years. For the same reason, I have a multi-cap strategy.

Q: Can you describe your perspective of growth?

A: I tend to be a GARP investor and to a degree contrarian. When earnings multiples get too high, even if the companies are great, all the growth potential is usually built into

the stock. My strategy is to buy growth stocks earlier, before they are fully valued. When expectations are high, if a company misses earnings even by a penny, the stock can fall by 20% in a day. I try to avoid this and to build a better risk/reward profile. But with the rise in value in the last few years, the differential between value and growth stocks is not as big as before.

Q: How do you implement this philosophy into strategy?

A: The first thing is the GARP strategy and looking for good, stable, growth potential and moderate PEG ratios, usually in the 1 to 1.25 range. I also look for balance sheets with less leverage, or for companies that are more defensive than their peers. Another factor I take into account is the enterprise value to sales ratio.

I usually look for dividend-paying companies, which comprise about 70% to 80% of the equity part of the fund. One of the reasons is the tax advantage. But more importantly, dividend-paying companies tend to be more stable, with more dependable accounting and free cash flows.

Fund Facts

Symbol	VALIX
Website	www.vlfunds.com
Address	Value Line Asset Management 220 East 42nd Str. New York, NY 10017-5891
Tel. No.	800-243-2729
Inception	10/1/52

Portfolio

Total Net Assets *	\$ 260
Avg Mkt Cap (\$ Weighted) *	\$ 23,100
Average Price/Earnings Ratio	18.1
Average Price/Book Ratio	2.3
Turnover Ratio	75 %

Investment Information

New Investment	Open
Min Initial Investment	\$ 1,000
Min Subsequent Investment	\$ 100
Min Initial IRA Investment	\$ 100

Risk (Against S&P 500 - 3 Years)

Alpha	6.23
Beta	0.60
R-Squared	77
Ann Std Deviation	7.05
Sharpe Ratio	1.80

Returns vs. Lipper Balanced Fd Index

	VALIX	Index
1 Year (Cum.)	13.20 %	7.16 %
3 Year (Ann.)	15.27 %	10.45 %
5 Year (Ann.)	3.55 %	2.58 %

Returns vs. S&P 500

	VALIX	Index
1 Year (Cum.)	13.20 %	8.72 %
3 Year (Ann.)	15.27 %	12.85 %
5 Year (Ann.)	3.55 %	-1.74 %

Fees and Expenses

Max Sales Charge - Front	0.00 %
Max Sales Charge - Deferred	0.00 %
Max Redemption Fee	0.00 %
Total Expense Ratio	1.10 %

Portfolio Manager

Brad Brooks CFA	Mar-2002
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* millions

Data through: 10/31/05

Source: Company Documents; Lipper



In terms of quality of earnings, I try to avoid companies with a lot of stock options because they dilute earnings. Pensions are another big issue, especially at the older industrial companies. They have significant underfunded pensions and I avoid this longer-term problem.

Lastly, I avoid the companies that are constantly taking one-time charges or as some have called them serial restructurers.

Q: *Can you explain your research process? How do you generate ideas?*

A: We run weekly screens on the basic ratios looking for new companies. Also, I spend at least a third of my day reading news publications, newsletters, and various sources of research. That results in another half dozen or so of names every week.

Once I have found something of interest, I decide if this is an area that I want to add to. I am not particularly worried about the weightings in the S&P 500, but I don't usually get too far away from them. Often a macro issue may be the reason to reduce or overweight a sector. Currently, I have only about half the weighting of the S&P 500 to the Finance sector since I am not very sanguine about the effects of rising short-term rates, the flat yield curve, and the exposure many of these companies have to the housing and mortgage areas.

Q: *Growth investors usually have a forward-looking view, while value investors place more importance on balance sheets, historical earnings, and cashflows. In your experience, which approach is more valuable?*

A: I like to think I use both these types of investment styles and a blended approach is really more effective. Hopefully, most of my investments meet the requirements of each

of these styles. I also believe being somewhat of a contrarian helps. For me the best way to make money is thinking about the best risk/reward in a long-term perspective. I take the consensus view and try to figure out where people are overly optimistic or pessimistic. A good risk/reward scenario tends to include some negativity on a company. When everyone is very positive, maybe the stock has another six months to run, but it could be a difficult long-term holding.

Q: *Why? Because it is prone to accidents?*



A: Yes. Unfortunately, when expectations are high, the stock easily becomes fully valued.

Unfortunately, analysts tend to extrapolate the growth from the past year into growth rates for several years ahead, while this may have just been unusually good year.

On the other hand, in energy for example, analysts constantly underestimate the earnings power there. This is a theme that I have benefited from the last few years. The price of oil can fall from \$60 to \$50, but some of the companies I own are selling oil in the mid-30s because of past contracts that will expire. For some reason, the analyst community hasn't picked up on that.

Q: *Does that situation apply to homebuilders also?*

A: Homebuilders are an interesting area. They may have a couple of growth quarters left and look cheap on a valuation level. For example, Toll Brothers is expected to make \$8.50 this year and \$10.50 next year, which is substantial growth. Its very low P/E makes it interesting. But 5 years ago, they were making \$1.40, while revenues have roughly doubled. Where is the extra profit coming from if revenues haven't jumped five-fold? Yes, housing prices have gone up and prices of commodities took a recent hit and that has helped them with the margins, but I think the pricing aspect is not sustainable. Houses can't keep growing at 10% to 15% per annum.

It also bothers me that many of these companies have gone to the financing side and aren't a pure play on homebuilding. If the housing markets slow down, there will be a compression on earnings, not only on pricing, but also on fee generation from mortgages. That's the big risk with homebuilders - even if the numbers have been spectacular, they are not that sustainable.

With energy, it is just the opposite. I don't have any idea where oil will be in the long run, but if it falls back to \$50 in the short run, many of the companies I own will still have similar earnings growth versus last year. Almost half of the growth in EPS expected for the S&P 500 this year comes from the energy sector, which is only about 9% of the index. At the peak in the early 80s, energy accounted for nearly 30% of the S&P 500. I am not saying that it is going back to that extreme level, but it would not surprise me if that over the next few years it will rise to the mid-teen area of the index. Demand from the U.S. and emerging markets such as China and India is driving growth about 3% per annum and if the global economy does weaken, a country

like Saudi Arabia could reduce production. Unlike the spike in oil costs in the seventies, which was cartel driven, the current situation is demand driven.

Q: *What energy companies meet your criteria?*

A: Devon Energy has been one of my largest holdings for several years, it is one of the cheapest in the industry. Last fall, when I was running a screen that breaks the energy sector into industries, I found Vintage Petroleum. It fell into my theme of small companies expected to trade at significant premiums. Its earnings estimates were low and most analysts were expecting them to fall, but they didn't. The recent price is 34, the stock is up almost 50% since I bought it and still trades at less than 10 P/E because of the strong earnings growth. It may be a nice fit for one of the large international majors as we are in the beginning of a consolidation in the energy sector.

Q: *How do you take decisions on the fixed-income side?*

A: I tend to be conservative there. The only lower-rated securities are convertible bonds. All the straight corporate bonds are investment grade. At this point, I am taking a fairly defensive stance and most of my holdings are short to intermediate range.

If rates continue to go up, I will be able to invest some of my cash holdings, which are about 13% of the fund, at better rates. Inflation has picked up, there is a significant flattening of the curve, and that's one reason for staying short. I don't think that 4.5% in the longer end of the curve is compensating me to go out further.

On the corporate side, I am looking for at least 5.5% or 6% yield in

stable and safe situations. A recent example is Sabre Holdings, a reservations company with low leverage; their debt is less than one-third of sales. It is not tremendously exciting, but in the environment we are in, if you can generate 6% over the next few years, that is a decent return.

The major concern I have on the

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about

Brad Brooks

Brad Brooks, CFA, is a senior portfolio manager with Value Line Asset Management. He is the manager of the Value Line Income and Growth fund (Balanced Equity) and the Value Line Aggressive Income Trust fund (High Yield Bond). He joined Value Line in 1997 as an Equity Research Analyst and began managing investment accounts for Value Line Asset Management in 2000. Mr. Brooks is a Chartered Financial Analyst who earned a BA in Economics from Vassar College and an MBA in Finance from Columbia University.

debt side is not the current issue of global savings, but the situation as I see it of excess money creation. In the US, we have started to slow down the growth of money supply, but in general, US, China, and to some degree Japan and Europe, are all printing money to devalue against their major trading partners. That has created an extra surplus of Treasuries for Japan and China, which circles back to the US debt market. If they decide to sell, or even scale down their buying, that will be a problem for our rates.

Q: *Would you explain your buy and sell discipline?*

A: Once I feel confident with a company, my buy decisions are fairly rapid. The fund isn't large, so it is easy to get a full position in a day or two. For riskier investments, I usually don't take a full position immediately. I tend to take larger positions in large more liquid companies and small positions in small or more volatile ones.

Right now I am 50% large cap and 50% small and mid-cap. Several years ago I had 65% in small and mid-cap stocks because of the quality of earnings. Most small and mid-cap companies don't have options or pension issues. Occasionally they have restructuring problems, but their balance sheets are much cleaner. Small- and mid-cap was a theme I had three years ago. As they rallied, I reduced the position. For a year now I have been adding large caps and I expect that to continue over the next year.

In general, I tend to scale out as stocks appreciate, even if everything looks good, I take some money off the table to reduce the position and the risk in the portfolio. Once I feel it is fully valued, I sell the entire position. If a stock doesn't do well and there is news that changes my outlook, I get out of the position fairly quickly. ■

TICKER Staff