

An Outside View to Value

The search for value is always difficult, but in a crisis environment, it can be a real challenge. For Thomas Schuessler, the manager of DWS Large Cap Value Fund, the analysis of various bottom-up metrics is only part of the process. The macro perspective on sectors and themes, the outside view from Frankfurt on the U.S. economy, combined with portfolio diversification and a stringent sell discipline, are key for avoiding value traps and for positioning the portfolio appropriately.

What is your investment philosophy and how does it differentiate you from your peers?

This is a value fund, which means that we try to buy stocks that are undervalued and we hold them until they appreciate. We are prepared to wait more than two years.

Unlike many of our U.S. competitors, we utilize both a bottom-up and top-down approach. In addition to reviewing balance sheet, business model and margin fundamentals, we also look for value opportunities at thematic and sector levels.

The macro view on which sectors could be of special interest is an important part of managing the fund. We have larger sector or theme bets on these areas of the market. For example, over the last couple of years we tended to have a large overweight in energy. Due to the current environment, that overweight is not that pronounced as it was in the beginning of 2008, but energy was a long-term theme, which offered good upside from a valuation perspective.

Another difference is that we run this U.S. value fund from Frankfurt, Germany which is quite unusual. That provides both advantages and disadvantages, but a clear advantage has been the dispassionate view on the U.S. market, particularly during the last two years. We could easily see that the U.S. housing market wouldn't be any different from any other housing market in the world and that it wouldn't go up forever.

For some reason, that realization has been very difficult for many U.S. managers.

I believe that this outside viewpoint from Frankfurt has resulted in a better view of the world and specifically the U.S. economy.

What metrics do you use to identify value?

We look at various parameters. Normally, investors tend to look at price-to-earnings ratios or at cash flow multiples, but right now it makes more sense to look for distressed companies and to examine the price-to-book ratios. We also use the dividend yield as a value metric for more stable companies, with higher generation of cash flow, and a very predictable investor return.

Overall, we make a distinction between classic value and contrarian value. The classic value company would have high dividend yield and a low price-to-earnings ratio. More importantly, it would have a stable business model and a high frequency of positive earnings. Such companies can often be found in the telecommunications, consumer staples and utilities sectors.

On the other end of the spectrum, there are contrarian value stocks, which usually trade below book value and require different metrics. The dividend yield and the price-to-earnings don't make much sense for these opportunities. Often the earnings have disappeared, but the balance sheet reveals the value. The contrarian value bets on these stocks represent an opportunity at the



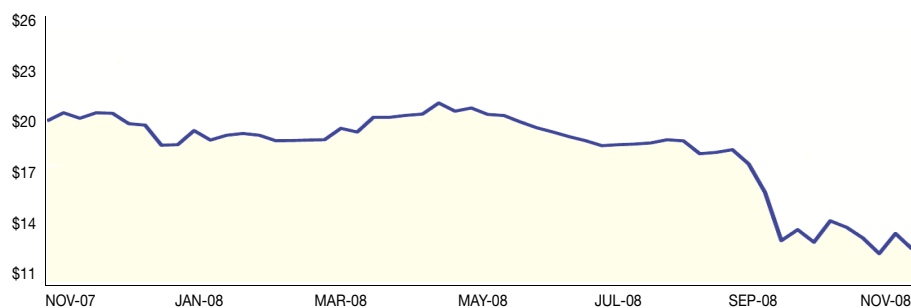
THOMAS SCHUESSLER, PhD, is a Managing Director and portfolio manager at DWS Investments. He joined Deutsche Bank in 1996 and has been managing value equities out of Frankfurt Germany since 2001.

Schuessler holds a PhD in physics from the University of Heidelberg, in addition to a diploma in physics and economics from University of Heidelberg and University of Utah, Salt Lake City.

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Performance - Price History N.A.V.

DWS Large Cap Value Fund (KDCAX.LW)



moment, because there is a lot of stress on the market. Now we are trying to increase our exposure to these deep contrarian value companies in anticipation of a possible market rebound in the future.

When the markets are at an inflection point, the price-to-earnings ratio of an oil company may be very low, but you may still have a significant downturn in performance. How do you protect from cheap getting cheaper?

It is absolutely true that a low price-to-earnings ratio doesn't necessarily mean that a stock is cheap. Financial stocks would be a good example. Last year Citigroup looked like a value stock but certainly it wasn't.

It was very clear that if these stocks traded on inflated and unsustainable earning numbers, if they were underweight on book value, they've never been cheap. That's an example of actually spotting value traps. A low price-to-earnings multiple certainly doesn't guarantee that you are invested in a value stock. It is a good indicator only if the earnings are stable, so certain additional assumptions are necessary.

So, we look at the price-to-earnings on a normalized basis. Some adjustments are always necessary to get an idea of whether the price-to-earnings level is sustainable. In the case of peak earnings, one expects only single-digit multiples, and in such cases, the book value is critical.

The price-to-book ratio of an oil company would actually show whether it is cheap or expensive. If an oil company trades at a P/E

of eight, but at a price-to-book of five or four, that usually signifies a very profitable business at peak margins, but not a cheap stock.

You need to have some idea about the longer-term oil prices to normalize the earnings. That means that you also need an idea of what the cycle will do; how severe a downturn would be; how much the oil price could fall.

What type of earnings do you prefer to analyze? Do you focus on historic or forward-looking numbers?

I believe that forward-looking earnings, just like any other predictor, are completely unreliable. I like to look at the earnings over the cycle, and I tend to go over the last 30 years just to see how the margins hold in upturns and downturns. Typically, I get a fairly good idea of what the earnings of a company could potentially be. Right now the analysis is difficult because this is a special cycle but, usually, going back in history provides data about how the company has behaved in a similar cycle.

The dividend yield, which is typically a more reliable metric for financial and insurance companies, has not been very indicative this year as many companies have cut their dividends.

That's true, but it is not surprising with the imploding earnings. Dividends usually are more stable because if earnings decline in a recession, the dividend can still be kept up with a higher payout. Of course, in the case of financials, the earnings imploded and there are huge balance sheet issues. If

the earnings collapse, it is impossible to hold up a dividend. For this sector and in this environment, the dividends have been a very misleading concept.

Again, it is the stability that matters. The dividends are still less volatile and more reliable than the price-to-earnings, but if the earnings go away, the dividends will go away too.

Could you explain your idea generation process?

Just like many fund managers, we run various screens on the U.S. market to generate ideas. We use different metrics, such as price-to-book, dividend yield, price-to-earnings, free cash flow and others.

The process starts with an internal discussion and with analysis of the companies, their upside potential, and the margin of safety. At the moment, the margin of safety is particularly important, and we need to have an idea of how low the stocks can go.

Finally, we need to build an opinion about the timing, because our average holding period is one to two years. I'm certainly not Warren Buffett and I can't keep stocks for the next twenty years. I need to see a catalyst in the foreseeable future to get a positive result. So, we differ from the deep value funds that can hold the stocks for more than five years.

Would you give us some specific examples that illustrate your thought and research process? What would be the reasons for selling a stock?

A good example is our underweighting in financials for macro reasons, not because of bottom-up analysis. The same macro view led us to an overweight in energy.

As far as our buy and sell discipline, we buy stocks that are very cheap and we sell them when they appreciate and reach fair value. At the moment, however, almost all of the stocks in the portfolio are far below fair value, so we don't have the chance to sell them for that reason.

Another reason to sell a stock would be cutting your losses if you feel that you made a mistake. If you feel that you have entered into a value trap, you must cut your losses. We have historically seen some of our divested value traps further deteriorate after we exited the positions,

How do you build your macro view?

We don't necessarily have a macro view on everything. We may have a macro view on certain trends, themes, or sectors. If we have a certain macro view, then it significantly affects our exposure. For example, last year our exposure to financials was 14%, compared to 40% in our benchmark, Russell 1000 Value.

Could you explain the portfolio construction process?

The portfolio consists of about 80 stocks that are almost equally weighted at 1% to 2% of the portfolio. The maximum exposure to a specific stock is 3%. Typically, I scale into stocks, which means that I buy them in increments of 30 to 50 basis points. The turnover is about 50%.

The fund is relatively small and is not market-cap weighted. The equal-weight approach represents a very different construction method. It means that I will not hold 8% in Exxon Mobil only because Exxon Mobil represents 8% of the benchmark.

Diversification is typically perceived as a hedge against market volatility. However, when the entire market has declined, diversification doesn't protect you. What is your strategy for minimizing the losses during crisis periods?

I believe that diversification still helps. With the way our portfolio is constructed, we avoid at least the large single-stock risks, which could be substantial. In a concentrated portfolio, that risk is much bigger. If you had 5% or 8% in AIG, for example, that would be a serious problem. We have seen in the past many prominent fund managers getting slaughtered because they had very large holdings in the wrong financial stock.

I still believe that a diversified portfolio with 80 stocks is the better strategy for a downturn

than a portfolio with 40 stocks. It may not protect you entirely, but it will reduce your losses, particularly when facing bankruptcies and closures.


What's your overall strategy for the current environment?

The magnitude of this meltdown is quite abnormal and, in the stock market, it usually doesn't pay to position yourself against doomsday scenarios. They are very hard to protect against.

At this point, the portfolio is still quite defensive, but there is upside for the stock market at least over the medium to the longer term. There's clearly a value in this market and many companies are trading at distressed levels. There are cheap companies out there and although they can get a lot cheaper, they are worth considering.

This is an event that only happens once in 50 years in the financial world. We were right with our analysis of the financial industry and we managed to keep our losses very small in that sector. However, we didn't anticipate that this would turn into a 50-year event for the world economy, and that the whole market would get hammered. How do you prepare for that?

There are real possibilities for the situation to deteriorate further, because the cure offered by the government in a way is worse than the disease. Still, I find it hard to believe that 2009 will be worse than 2008, because that would mean an economic catastrophe and a market trading far below book value.

First, diversification and avoiding concentrated bets is very important in this market. Second, I monitor the fund daily in terms of price, absolute and relative volatility, and return profile. We have Value at Risk reports that give us an idea of how volatile a position is and how much money we could lose in a certain scenario. We also use research tools to know the single-stock contributions to risk, the macro contributions to risks, and to find out the unintended bets in the product. 

DWS Large Cap Value Fund

Symbol	KDCAX.LW
Website	www.dws-investments.com
Address	DWS Investments 222 South Riverside Plaza Chicago, IL 60606-5808
Telephone	800-621-1048
Inception	03/18/1988

PORTFOLIO	
Total Net Assets*	\$1,500
Avg Mkt Cap (\$ Weighted) *	\$58,600
Average Price/Earnings Ratio	12.43x
Average Price/Book Ratio	2.43x
Turnover Ratio	86%

INVESTMENT INFORMATION	
New Investment	Open
Min Initial Investment	\$1,000
Min Subsequent Investment	\$50
Min Initial IRA Investment	\$500

RISK (AGAINST S&P 500 DAILY REINV IX - 3 YEARS)	
Alpha	0.23
Beta	0.99
R-Squared	0.91
Ann Std Deviation	15.63
Sharpe Ratio	-0.54

RETURNS VS. S&P 500 DAILY REINV INDEX		
	KDCAX.LW	Index
1 Year (Cum.)	-34.81%	-38.09%
3 Year (Ann.)	-6.03%	-8.67%
5 Year (Ann.)	-0.39%	-1.39%

RETURNS VS. RUSSELL 1000® VALUE INDEX		
	KDCAX.LW	Index
1 Year (Cum.)	-34.81%	-38.32%
3 Year (Ann.)	-6.03%	-8.55%
5 Year (Ann.)	-0.39%	0.13%

FEES AND EXPENSES	
Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee**	2.00%
Total Expense Ratio	1.00%

PORTFOLIO MANAGER	
Thomas Schuessler	2007

*millions **1 month after purchase
11/30/2008; Source: Company Documents; Lipper

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