

# Small Cap Wonders

*The Walthausen Small Cap Value Fund invests in small cap companies that are believed to have the potential for capital appreciation. When choosing a company the Fund manager John B. Walthausen focuses on the sustainability of its business model, the ability to generate cash flow and the opportunities that it has to reinvest in businesses that could substantially improve its value.*

## What is your investment philosophy?

We are specialists in small cap value stocks and consider ourselves as buyers of businesses and not just investors in stocks. We find stocks from time to time are substantially neglected and may be trading below their intrinsic value. We approach investing in stock as a buyer of businesses and look at it as if we are buying a stake in a company rather than a stock. We focus on the sustainability of the business model, their ability to generate cash flow and the opportunities that they have to reinvest in businesses that could substantially improve the value of the company. We believe that over time that potential should be recognized by the stock market.

## How do you translate this philosophy into your investment strategy?

Rather than focusing on what the near-term earnings per share outlook is, we want to focus on what the real value that a businessperson would see in it. If a company is generating a good cash flow

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and reinvesting it successfully, that will result in good growth and earnings per share and that should get recognized by the market.

Thousands of companies fall within the small cap arena and academic literature suggests it is often the smaller, most neglected end of the market that does quite well. However, those stocks often trade very poorly. That neglect often translates into a mispriced stock.

## How do you research these companies?

We’ve developed over the years a process of scoring the entire universe of small cap companies. We are not looking for a perfect company but we are looking for a company where there is evidence to suggest something interesting is happening and the stock is trading at a reasonable valuation.

We rank the universe on a dozen different criteria, weigh each of these factors, and come up with a combined scoring. That helps us to focus on companies that tend to be more promising than the average.

I think the core value that we add to the equation is when we go back and look at these companies in a very detailed way. That means building up spreadsheets of all



**JOHN B. WALTHAUSEN, CFA** – Managing Director, Chief Investment Officer & Portfolio Manager, Walthausen & Co., LLC, and Portfolio Manager for the Walthausen Small Cap Value Fund.

Walthausen has developed a well honed understanding of investing in small cap value stocks over his 35 year career. He initially became interested in the ability of cash flow analysis to predict stock performance when working as a credit analyst covering industrial, technology and aerospace companies in the 1970’s.

In 1994, Walthausen became a founding member of the Paradigm Capital Management investment team. He served as co-manager of institutional accounts for several years before developing and managing the Paradigm Value and Select funds, and formed Walthausen & Co., LLC in August, 2007.

Walthausen graduated from Kenyon College and has advanced degrees in architecture from City University of New York and Finance from NYU.

the accounting data that's available. We look at the income statement, balance sheet and tie it all together with the cash flow. We try to figure out if the company is likely to predictably generate more than enough profit to sustain itself and how much would still be available for investments in growth, debt repayment or other value enhancing moves. If there is significant and sustainable excess cash flow, we look to see if the company has a history of successfully reinvesting excess cash. If it looks like there are opportunities for them to continue to reinvest, we are interested.

**Your screening process relies on what market is not interested or ignoring rather than on concentrating on few companies that you prefer to invest and wait for the appropriate market valuation. What are the merits of your preferred way of investing?**

I have done it both ways. I believe that our process is robust and the team deep enough to find a sizeable number of good investments. So we can have our cake (diversification to reduce risk) and eat it too (good returns for investors). We believe that good research is time sensitive. We focus on finding undervalued stocks with potential for appreciation.

I think the hazards of a concentrated portfolio are great. We are not all seeing. When you do investment research you build on certain assumptions about the company and the economic environment. We do not feel that you can anticipate all the changes which will occur over the next several years. The business may change because the industry is changing, or because management has suddenly changed its outlook, expectations, ambitions or strategy. We try to protect against adverse developments through diversification and cautious analysis and valuation.

We often find the more fruitful stocks are the ones that the world has given

up on. We are not afraid to look hard at companies that have disappointed investors. Our scoring model tends to identify a company to look at after it has passed through a rough period. Of the companies that are thrown up by the scoring model, we must evaluate whether that industry is still deteriorating or whether the worst has passed. We do think that it is very fruitful to look at companies after they have fallen from favor. We need to work hard to find companies that have good business models and good management. Thus many of our best picks are stocks where there are real and obvious reasons to avoid them. This system forces us to look deep and do the fundamental analysis.

I began a process of building a scoring model so that I could do what I had been doing intuitively as I looked from stock-to-stock. The scoring model included factors I looked at as good indications of what was likely to work. I also began a process of standardizing the financial models. The model also helps me to set aside my emotions and stay objective.

**Can you give us examples of companies that you invested in based on your screening and research process?**

We began to invest in Ocwen Financial Corporation, a subprime mortgage collector, loan servicer and receivable management services provider, last May. I took a quick look at it when it came up high on our scoring system. I dug deep and began to understand the dynamics of the market they were working in. The business which they had built up gave them a lot of control over how to deal with problem mortgages. The thing that was creating a lot of pressure on them was slower collections, which put pressure on the amount of capital they needed because they needed to fund the trust on a timely basis. However, since they fell first in line to be paid and they could and did renegotiate and/or walk away, they did have a means to deal with the building crisis. I could also

see that there was evidence they were effectively dealing with this and bringing their average collection period down.

They had invested a lot in software for helping their servicing agents to effectively deal with the mortgage holders in order to affect a solution to problems much more quickly. Also, the stock was selling substantially below tangible book value. As we got to know the company, we recognized that there was some real merit in their approach. It is not a name that you'd superficially love. It is only when you really began to take it apart and understand where the cash could come from and how they could invest it successfully.

When we see a company that has some problems and find it difficult to understand, we break it down into its component parts. We dive into the accounting and follow the cash. If we understand where the stress points are and what they are doing to correct those points, we may find an interesting stock.

Another interesting one is Nobel Learning Communities, Inc. The company has a network of 180 private schools and provides education from preschool to eighth grade education. When the current management took over the business five years ago, the company was a mess. The balance sheet was leveraged with various debt and preferred stock and the schools were performing poorly. They had not taken best practices across the entire system. The new management was focused on improving operations, and marketing. They brought the company up to speed, began to generate good returns, good retention of students, and started to turn it to creating good cash flow. This has been reinvested in the company to improve operations, to bring the balance sheet to a position of greater strength, and to start to grow the business.

### How much effort do you put in understanding the competitive dynamics of the situation?

It is important. We like to identify who the competitors are and what the ease of entry is, but we are ultimately trying to understand a company's ability to have some control over its pricing and some ability to adjust pricing as needed for changes and cost. No company is perfect, but we grade them as companies with no ability and those with a lot of ability to control pricing.

We have no problem in playing in industries where a company doesn't have a lot of control in pricing. Currently, we are low on our energy exposure but a year ago we had a large position in energy stocks. In trying to select them, we recognized that they had absolutely no control over what the price of natural gas or petroleum might be. We needed to concentrate on understanding how effective they were in developing reserves and bringing production in at good costs, and whether they could avoid the risks of overexpansion in a volatile industry.

We were also very willing to invest in banks. It is difficult for any one bank to control what the interest rate will look like. Their cost of funds and the rate at which they can lend is largely a function of the prevailing interest rates. We look for companies that have strong balance sheets and are effective in controlling their credit and liquidity risks. We also look to see if they have developed a good customer base.

### What is average holding period in stocks you invest?

We are looking for a return over a two to three year period, which, in a normal market environment, is generally translated into a 30% to 50% turnover.

However, over the past year, we've been in a period of extraordinary volatility where we have needed to reevaluate our outlook for a number of companies. We have seen dramatic changes in the

economy and had to move away from some companies that had leverage. In a flat to up economy, that leverage could have worked for investors. A more difficult economy was putting some of these positions at risk. As a result, we had a turnover of 130% in the Fund over the past year.

We concentrate more on the idea of a target price. We review the price frequently but will reduce our exposure to a stock and reevaluate the target price depending on the market dynamics. The greater question is whether you buy the stock at this price at this time. If the answer is yes, then we feel we've reduced risk somewhat by rebalancing, and then we'll set a new target price.

We are cognizant of business cycles and we anticipated that we were coming to the end of a business cycle and were positioned more conservatively than we would have been in the early stages of a business expansion. However, we did not anticipate the severity and the speed of the current downturn. Once we began to recognize that, we had to readjust. Now, with signs that the economy is stabilizing, we need to shift the portfolio towards companies that will do well in the early stages of an economic expansion.

### What is an appropriate benchmark to evaluate your performance?

We benchmark ourselves to the Russell 2000 Value index. The index is heavily involved in the financials, probably heavier than we would dare to be involved. We like to have a diversification but we think it's a good comparison because it closely mimics the market cap of the stocks that we invest in and a lot of the valuation parameters are consistent.

### Generally, how many stocks do you have in your fund? What kind of sector diversification do you have and what percentage positions do you have per stock?

We have about 70 names in the

## Walthausen Small Cap Value Fund

Cusip	933310104
Website	<a href="http://www.walthausenfunds.com">www.walthausenfunds.com</a>
Address	Walthausen & Co LLC 9 Executive Park Drive, Suite B Clifton Park NY 12065
Telephone	518-348-7217
Inception	02/01/2008

PORTFOLIO	
Total Net Assets*	\$7.0
Avg Mkt Cap (\$ Weighted) *	\$736.9
Average Price/Earnings Ratio	15.9x
Average Price/Book Ratio	1.67x
Turnover Ratio	N/A

INVESTMENT INFORMATION	
New Investment	Open
Min Initial Investment	\$2,500
Min Subsequent Investment	\$100
Min Initial IRA Investment	\$2,500

RETURNS VS. S&P 500 DAILY REINV INDEX		
	Fund	Index
1 Year (Cum.)	-38.23%	-43.32%
3 Year (Ann.)	N/A	-15.11%
5 Year (Ann.)	N/A	-6.63%

RETURNS VS. RUSSELL 2000 VALUE INDEX		
	Fund	Index
1 Year (Cum.)	-38.23%	-43.03%
3 Year (Ann.)	N/A	-18.58%
5 Year (Ann.)	N/A	-6.64%

FEES AND EXPENSES	
Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee**	2.00%
Total Expense Ratio	1.25%

PORTFOLIO MANAGER	
John B. Walthausen	2008

\*millions \*\*3 months after purchase  
02/28/2009; Source: Company Documents; Lipper

portfolio right now. That's spread across most, but not all, sectors. We don't try to mimic the benchmark in terms of industry concentration but we do like the risk control that's associated with the diversification across industries and number of names.

Typically, we do not like to have a large concentration in any one name. Currently, our largest positions are about 3% of the portfolio. We have a rule that once it crosses 4%, we'll start to scale it back. Typically, on an initial position, we'll invest no more than 2% of the portfolio.

### **What are your risk controls?**

The first level of risk control is knowing your companies well. We do all the business modeling and read all the material that's available about the company. We try to understand the industry and how it works so that when there's an announcement of earnings, an acquisition, or news relevant to the company, we can better interpret and make a good assessment.


At particular times in the market cycle, we will knowingly take greater risks if we feel that over a period of time the economy is more likely to be expanding than contracting, and where we are more likely to see looser credit rather than more constrained credit. We will take positions in companies that are

highly leveraged, may be sensitive to the economy or even have both of those characteristics. During other periods, we need to actively rein in the risk characteristics of the portfolio.

We think that there is an enormous amount of information lurking in the public filings. We like to supplement that with discussions with management and meet with management from time to time. But all fundamental research has to be followed up with common sense financial analysis, and public data has to be reviewed with skeptical eyes as an investor. Business cycle related performance has to be segregated from the management effectiveness and company products or services acceptance in the market place.

Unless you have a strong understanding of why the market might improve, and that it's an extraordinary value, it's probably an industry that you stay away from. There are industries that we won't invest in like bio technology, apparel retailing and home builders.

### **How has the market treated you in the last eighteen months?**

We started up in September of 2007 and launched the mutual fund February 1st of 2008. We've been pleased with our ability to outperform our benchmark index in the first year, particularly in such a difficult market environment. 

### **Disclosure**

The commentary contained in this interview represents the responses of John Walthausen as of April 2, 2009, and is subject to change based on market and other conditions. The Walthausen Small Cap Value Fund may hold certain of the securities mentioned in the article, but may not currently hold or continue to hold the securities. These comments provided are not intended to be a forecast of future events, a guarantee of future results, or investment advice. The information provided is not to be construed as a recommendation or an offer to buy or sell or the solicitation of an offer to buy or sell any fund or security. Investors should consider risks, charges and expenses carefully, which are detailed in the Fund prospectus. Please read the prospectus carefully before investing. For further information about the Walthausen Small Cap Value Fund, please visit [www.walthausenfunds.com/](http://www.walthausenfunds.com/) or call (888) 925-8428.

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