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## **Stock Highlight: Gamco Investors, Inc. (GBL)**

One of my favorite industries to invest in is the asset management industry. The main reason is that the industry has the attractive characteristics I described in my investment strategy. History has also shown that an investment in an asset manager has far exceeded the returns of investing in a top mutual fund. This makes perfect sense, as a mutual fund performs well it grows in size. Thus the asset management company makes a lot of money.

In the past year I have done very well investing in companies like Franklin Resources (nyse: BEN), U.S. Global Investors (nasdaq: GROW), Hennessy Advisors (otc: HNNA) and Diamond Hill (nasdaq: DHIL). I recently took a look at Gamco (nyse: GBL) and I must say I liked what I saw.

Gamco was founded by Mario Gabelli in the 1970's. Mario Gabelli is well-known value investor, who has focused on media, telecom, and technology issues. He looks for companies that are trading at a discount to their private market value and have a potential catalyst to narrow the discount. He has even trademarked his approach as "Private Market Value (PMV) with a Catalyst." Gamco's 2005 annual report details Gabelli's approach:

PMV with a Catalyst investing is a disciplined, research driven approach based on the extensive use of security analysis. In this process, we carefully select stocks whose intrinsic value, based on our estimate of current asset value and future growth and earnings power, is significantly different from the value as reflected in the public market. We then calculate the firm's PMV, which is defined as the price an informed industrial buyer would be likely to pay to acquire the business.

To limit the time horizon in which the PMV is likely to be realized, we look for situations in which catalysts are working to help eliminate the premium or realize the discount between the public market price and the estimated PMV. Catalysts which are company specific include: realization of hidden assets, recognition of underperforming subsidiaries, share buybacks, spin-offs, mergers and acquisitions, balance sheet changes, new products, accounting changes, new management and cross-shareholder unwinding. Other catalysts are related to industry dynamics or macroeconomic and include but are not limited to: industry consolidation, deregulation, accounting, tax, pension and political reforms, technological change and the macroeconomic backdrop. The time horizons for catalysts to trigger change can either be short, medium or long-term.

(As an aside, a number of years ago I incorporated Gabelli's catalyst approach into my own investment strategy; however I tend to focus on short and medium term catalysts only. I found that the purchase of longer term catalyst stocks usually did not turn out as profitable for me. So I adopted a "retailing approach" in that I would rather turnover my investment funds more times with modest returns than fewer times with a large return. Essentially I prefer to own a series of stocks that are selling at smaller discounts, of say 20-25% that narrow, than one stock that is selling at a huge discount but needs a long time frame to work out.)

Gamco went public in 1999 by selling six million Class A shares at \$17.50 per share. Mr. Gabelli retained effective control through his ownership of 24 million Class B shares. The shares rose to \$48 by the summer of 2001. Since 2001 the shares have performed poorly, despite positive growth in the underlying business, and currently it trades at \$40 per share.

### **The Good**

Once I dug into the financials I was impressed by the many favorable things I saw. Net cash, including investments, was nearly \$420 million. Long term debt is at rates below 6%. In fact, \$50 million of the company's debt is a 6% convertible, owned by Bill Gates, which can be converted into common shares at \$53 per share. Of the current 28.3 million shares outstanding, Mr. Gabelli still owns 20.8 million shares. Large fund companies own approximately 3 million shares. A former founder owns 2 million shares, and directors of the company own an additional 0.2 million shares. Thus the public float is only about 2.3 million shares.

What amazed me was that in the last year the company had repurchased 1.7 million shares. If that repurchase rate were to continue, the public float would be gone within two years. It seems logical that something favorable will happen by then. Either continued buybacks will help increase the share price, or a going private transaction, debt reduction, acquisition, or increased dividends will.

### **The Bad**

Of course no company is perfect. The biggest negative on the stock is that Mr. Gabelli is paid a significant salary. In 2005 he received \$55 million in total compensation out of the \$118 million of total compensation the company paid. Clearly that has a negative impact on earnings. But as a recent Motley Fool article noted, it is unlikely that he will pay himself more due to the bad publicity. If it stays the same nothing changes. And if he paid himself less, which is unlikely, that would be very favorable to the share price.

### **The Risks**

Obviously being an asset management company it faces overall market risk. If the stock market were to fall, it could lead to not only lower assets under management but also to potential redemptions, which would compound a decline in earnings. But investing with the belief that a market depression might soon happen is foolish. Sure corrections, or even "crashes" that may take a year or two to recover from will occur, but the likelihood of a sustained bear market is fairly low in my mind.

The biggest risk is probably that something unfortunate health wise would happen to Mr. Gabelli. Yet that is mitigated by his huge salary. If something unfortunate did occur and it resulted in a loss of assets under management, it would also result in the elimination of a significant amount of the company's costs.

### **Conclusion**

Gamco falls under the category of having a medium-term catalyst. While I prefer short-term catalysts, medium-terms have typically performed well for me. The company trades at about 18 times earnings, which is in line with the industry, yet Gamco has a stronger balance sheet than its peers. Its growth rate is not such that the shares are likely to double in the next two years, but it seems very likely that its shares can gain 20-30% within the next 12 months.

*Note: Due in part to his success at Marketocracy, Mr. Eriksen has registered as an Investment Advisor. Both Mr. Eriksen, and funds he manages, have a position in Gamco.*