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Funds in Focus

Fund in Focus: New Market Fund

Stephen M. Goddard, manager since October 1998.

S&P Rank: 5 Stars

Dining At The "Buffett" Table

March 9, 2004 -- Stephen Goddard is a great admirer of investment guru Warren Buffett. In fact, he is so enamored that Goddard's mutual fund, the \$6-million [World Funds:New Market Fund](#) (AVMIX), has a 23% stake in Buffett's Berkshire Hathaway`B` (BRK.B).

Based in Richmond, Va., Goddard takes a Buffett-style approach to large-cap core investing: He favors stocks of big companies with predictable, sustainable fundamentals, stable cash flows, high profitability, financial stability, the ability to consistently generate at least 15% annual returns on capital, and that trade at reasonable valuations. He also puts great emphasis on managements with strong commitments to shareholders.

Goddard's methodology is purely bottom-up. He completely eschews macroeconomics, or the "noise" of Wall Street analysts.

The fund, which Goddard has run since its inception in October, 1998, typically carries just 20 to 25 stocks. The manager likes to maintain a heavy emphasis on his "best ideas." As a result, the top ten stocks can represent as much as 75% of the portfolio's total assets.

For the 12-month period through Jan. 31, 2004, the fund gained 33.7%, closely matching the average large-cap value fund, which rose 33.9%. For the three-year period, the fund rose 4.1% annualized, versus a 0.5% drop by the peer group. For the five years, the fund gained 3.6% on average, edging out the peer group, which rose 3.2%.

Goddard said his portfolio is designed to "participate in 75%-90% of up-markets, and just 50% in down-markets." This means that during a normal bull market, the fund should participate in 75%-90% of the market's upside; and in bear markets, it should only fare half as poorly as the overall market.

That is, indeed, what has happened. In 2003, a bull year, the fund gained 23.6%, slightly underperforming the S&P 500, which rose 26.4%. In the three years before that, despite the bear

climate, the fund outperformed the index while exhibiting less volatility, according to Standard & Poor's data.

As of Jan. 31, 2004, the fund's top ten holdings are Berkshire Hathaway (BRK.B), 23.0%; White Mountains Insurance Group (WTM), 6.2%; Markel Corp. (MKL), 5.6%; Gillette Co. (G), 5.5%; Ambac Financial Group (ABK), 5.0%; First Industrial Realty Trust (FR), 4.7%; FedEx Corp. (FDX), 4.4%; Liberty Media `A` (L), 4.2%; United Dominion Realty Trust (UDR), 4.0%; and NEXTEL Communications `A` (NXTL), 4.0%. These positions represented 66.7% of the fund's total assets.

Goddard points out that high concentration does not necessarily equate to high risk, as long as one has done the homework. Indeed, the fund boasts significantly lower risk parameters than its peers. Moreover, the fund's annual turnover rate rarely exceeds 25%, far below the peer average.

Funds with a hundred stocks and small individual positions, Goddard believes, are "over-diversified," and are unlikely to ever beat their benchmarks, since they don't have meaningful positions in any stocks that outperform. As of Jan. 31, 2004, the fund's largest sectors comprised financials, 39.9%; consumer goods, 12.6%; REITs, 8.6%; and insurance, 6.1%.

"We have a very high degree of confidence in Berkshire Hathaway," said Goddard. "Our initial position in the stock was 15%. It has everything we are looking for: consistent high returns, increasing book value, a solid business model, robust cash flows, a very shareholder-oriented management team, and the stock still trades at a reasonable valuation." Berkshire's Class B shares trade at about \$3150/share, Goddard thinks it should currently be valued about 15% to 20% higher.

Goddard also likes insurance companies White Mountains Insurance and Markel Corp., since, on the whole, the insurance industry is blessed with consistent returns, a competitive pricing position and reasonable stock valuations. White Mountain, whose management team is praised by Goddard, "could increase in valuation to \$750/share in three to five years from the present \$480 level."

Markel, a specialty insurer, has generated returns in excess of 20% for the last 20 years, and should continue to do so for the next five years, he forecasts.

Real estate investment trusts, Goddard notes, provide stability and income, particularly in a challenging market climate. Two of his largest holdings are in this sector. REITs provide modest stock price appreciation potential, typically 1% to 2%, but strong dividend yields of 6% to 7%, creating returns that should beat the overall market.

Goddard is wary of stocks with high projected growth rates, particularly tech and biotech, which are often priced on these future projections. While conceding that some big-cap tech stocks have matured into well-established businesses with solid fundamentals, they remain vastly overpriced, he says. Goddard expects the Nasdaq to underperform in 2004.

The fund has a somewhat high expense ratio of 1.99%, versus 1.39% for the peer group. Goddard attributes this to costs associated with running a small fund, but adds that the portfolio

will double in size shortly with the merger of another portfolio.

Looking ahead, Goddard forecasts a lackluster U.S. stock market. He believes the Dow will be range-bound between 8,000, to 11,000 for the next five to ten years, and that stock-pickers should outperform indexers as a result. The best-performing stocks, he posits, will have strong cash flows.

In addition, as companies face limited internal growth and stockholder pressure, they may be forced to return capital to their shareholders in the form of dividends. He also expects M&A activity to accelerate across all sectors, citing, among other things, excess capacity, and too many struggling and marginal companies in each major industry.

--Palash R. Ghosh