AGORA
FINANCIAL

NOVEMBER 2014

CAPITAL & CRISIS

Three Deep-Value Stocks

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I am always ready to go anywhere in search of investment ideas and insights. But for once, I didn't have to go far. In my own backyard, at the Mayflower Renaissance hotel in Washington, D.C., Roumell Asset Management held its annual Investor Day.

Jim Roumell is another investor who likes to go where the herd is not. He founded his own firm in 1998. He's done well since. Roumell's SMA Opportunistic Value Composite is up 333% through June 30, compared with 113% for the market. He graciously extended an invitation to yours truly, and I happily went.

It's strange that we had not met before, because we think a lot alike. Roumell too is an enthusiast of Marty Whitman's deep-value approach. (Whitman was the longtime manager of the Third Avenue Fund and an investment theorist of the first rank.) In an interview in the 2009 issue of *Value Investor Insight*, Roumell talked about how "a light bulb just switched on when I read everything Marty Whitman wrote."

It's a good way to be. And Roumell created a firm focused on deeply researched out-of-favor ideas. "We describe our investment discipline as 'price per pound,'" Jim says, "by which we mean our portfolio is comprised of securities that 'weigh' a lot more today than is implied by the price we paid, as opposed to being highly dependent on future events to increase weight."

It's been tough to be this kind of investor in the last couple of years. Trying to find a bargain in this market is like shopping for deals at Tiffany's. At the meeting, Roumell ran through a variety of metrics that show how the stock market trades well above historical averages. We are in danger territory, clearly.

But what happens in markets like this one is that the disciplined, smart investors lag the market. Meanwhile, the wild yahoos — inattentive to risk and price — sail on ahead. Psychologically, this is hard to stomach. It also means that your clients will start to leave you. (One value-minded manager I know, who is really good at protecting capital, told me that "Every day, somebody is firing me." Meaning, people are taking money out of his fund to put it with the yahoos.)

Long-term success in the market means sometimes you have to trail behind so as not to get ambushed later.

Roumell is surely feeling some heat, as RAM has trailed the market for the last three years. That's because he's been cautious. RAM carries a lot of cash, which drags down returns. So far in 2014, for example, RAM averaged 40% in cash. But he did a good job reminding his investors of the importance of sticking with this value-based, conservative approach.

He showed how he sidestepped the tech bubble in 2000. From 2000 through the bottom in 2002, RAM investors enjoyed a 29% total return, versus a 37% loss for the market. When the market fell 37% in 2008, RAM was down 27%. The rebound in 2009, though, delivered a 42% return, versus just 26% for the market. RAM investors were ahead in those two years, while the market overall was in pain.

Roumell avoids pain, too, by not owning too many stocks. Roumell's portfolio usually has just 20–30 names. (Typical funds might have 100 or more.) As of June 30, the top 10 made up almost 40% of his portfolio. He focuses on his best ideas on the theory that his top ideas ought to outperform his second-tier ideas.

Roumell actually tested this theory. He performed a study of all the stocks his firm bought since inception — 308 investments in 226 distinct names. And what he found was that the names in which he had at least 5% of the portfolio invested returned 25% annually — versus 19% for the portfolio overall. Also, his win rate on 5%-plus positions was 85% — versus 66% overall. I think this pattern will prove true for most investors. (As I like to remind you, no need to own so many stocks. Focus on your favorites.)

Anyway, Roumell invited the CEOs of a few of his largest positions to speak to the group. These stocks are all down since the meeting. They are good values in today's market. Let's go through them.

SeaChange International (SEAC:nasdaq) is a software company that handles advertising for cable companies. It generates $130 million in sales. The market values the stock at less than 2 times sales. Yet Cisco acquired a competitor (NDS) for 5 times sales. Importantly, SEAC recently beat out NDS and won the Liberty Global account. Plus, SEAC had $111 million in net cash.

Valuing the stock at cash plus just 2.5 times sales yields a value of $435 million, or about $13 per share. That would be good for an 86% gain from the current price. Roumell has a lot of confidence in the CEO, Raghu Rau (who spoke at the meeting).

Another idea is Sizmek (SZMK:nasdaq), which manages online advertising campaigns. It is a major player in this market and will generate sales of around $184 million this year. The company is cash rich with $98 million in net cash. The stock trades for less than 1 times sales, after adjusting for the cash, versus prices of 2.5 times for transactions involving peers. Roumell pegs intrinsic value at $13–15 per share. With the stock at $8 per share, that's 88% upside at the high end of the range. Additionally, the chairman and CEO own 14% of the stock.

Finally, and perhaps most interesting, was Rosetta Stone (RST:nyse). The foreign language company is a top brand. CEO Steve Swad (who spoke at the meeting) joined in 2012 and agreed to take over 60% of his compensation in stock. Rosetta has a growing subscription business with 75% renewal rates. This business generates $100 million in sales. Rosetta also has $47 million in net cash and a consumer business that generates $200 million in sales.

Rosetta in July bought a company called Lexia, which serves 14,000 schools and over a million students with its English-reading software. Rosetta paid $22 million for this business. Already, Rosetta has boosted the value of this business by selling into its customer base. CEO Swad said that if you offered him $60 million for it today, he'd say no.

Rosetta ought to generate $10 million in free cash flow this year. Roumell pegs intrinsic value at $14–18 per share. The stock currently goes for $8.

These ideas are a bit out of my bailiwick, being software related. But they are interesting ideas nonetheless, and I pass them on to you to pursue on your own. I also admire Roumell for sticking to his principles in what is an agonizing market for a value guy. As he wrote in his latest quarterly letter, "Most of the pitches thrown by the market are well outside our strike zone. At some point, the market will get a better pair of glasses and start throwing right down the middle. When that happens, we will swing hard. Now is not the time to abandon our strict price-conscious discipline."

I second his advice.