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MUTUAL FUNDS

MUTUAL FUND PROFILE

Keeley Finds Fallen Who Get Back Up

Picked Texas Industries

Small Cap Value weighs stocks that Wall Street tramples on or ignores

BY PAUL KATZEFF
INVESTOR'S BUSINESS DAILY

Like a jungle predator, fund manager John Keeley Jr. preys on the wounded and newborn.

Keeley, 64, targets such frail firms because their prices are right. While other investors shun them, he expects his quarry to rally.

Keeley, who runs $375 million Keeley Small Cap Value Fund[KSCVX], holds five types of vulnerable firms. Those include spinoffs, bankruptcy survivors and S&L and insurers converting to stock ownership from mutual ownership. He also targets companies trading below book value, and floundering utilities. (See Mutual Fund Profile from 7/23/2002.)

What the five have in common is that target firms are often going through a restructuring.

If Keeley finds one he likes at about a 20% discount to what he considers its fair market value, he moves in for the buy.

The strategy has worked. This year going into Thursday, the fund was up 3.27% vs. a 0.31% loss for mid-cap blend funds tracked by Morningstar Inc. and a 0.04% loss for the S&P 500.

Over the past five years, the fund's average annual gain was 18.56% vs. 11.13% for its peers and a 1.20% loss for the market bogey.

Keeley sees no problem with a shareholder treating the fund as a core holding. "Any time you're able to buy things as a 20% discount to fair market value and score gains, that fund should hold up during all types of markets," Keeley said.

Keeley's also not concerned about a market rotation away from small caps or value-oriented stocks.

His specialized strategy is an all-weather approach that, he says, works no matter what's in vogue.

You won't find medical or software names in the fund, and nearly no tech. Their product life cycles are too short, Keeley says. The fund gets the best results by giving stocks three to five years to straighten out.

Ailing Utilities

Wounded utilities are newcomers to Keeley's restructuring theme, arriving in the past few years.

They were blindsided by deregulation. "These are companies that went into businesses that their management didn't understand," Keeley said. "They bought those new lines at the wrong price. They used debt to do it, and it blew up on them."

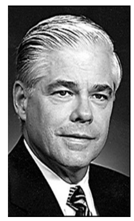
Spinoffs account for the largest number of Keeley's holdings.

Texas Industries[TXI] is a recent example. The fund bought it about a year ago. Its average cost is 43.23.

Now trading around 64, the firm announced on Dec. 15 the tax-free spinoff of its steel operation.

Keeley says the parent company is likely to benefit even more than the steel unit. It will be able to focus on its core business, making and selling cement, concrete and other construction aggregates.

Keeley Small Cap Value



- Manager (yrs.): John Keeley Jr. (11)
- Assets: $375 mil
- Ticker: KSCVX
- Expenses: 1.53%
- Ph: (888) 933-5391

Returns as of 2/16/05

2004: 32.90% 3-yr. avg.: 20.27%
YTD: 3.27% 5-yr. avg.: 18.56%

Top-rated holdings	EPS Rating	RS Rating	Acc/Dist Rating
Commercial Metals	91	97	B+
Quicksilver Resources	92	96	B
Levitt	98	86	B-

"This spinoff will unlock value," Keeley said. "Both businesses have been gaining momentum on overall economic growth."

Most of his newest opportunities have been in the energy and industrial sectors. The fund bought AK Steel Holding[AKS] about a year and a half ago. The stock is up nearly 20% this year and 260% from a year ago.

It broke out from a cup-and-handle formation on Feb. 14.

"Broadly speaking, AK Steel and Oregon Steel[OS], another holding, are examples of the reawakening of the American industrial heartland," Keeley said. "Companies have been on their backs for 20 years. But these companies have seen demand increases from overseas, which have bolstered their revenue and earnings. It's a play on economic activity in China and India."

Danielson Holding[DHC] is an insurer with investments in industrial-oriented activities. The fund's original interest was triggered by events that beat down the firm's value.

Danielson has an equity interest in marine transportation and services through its investment in American Commercial Lines.

In 2003 American Commercial filed Chapter 11 bankruptcy. Danielson took a write-off for its investment.

In December 2003 Danielson bought the energy and water businesses of Covanta, which was emerging from Chapter 11.

But Danielson's units have sound fundamentals going forward, Keeley says. And he figures the fund's average cost of 7.35 was a good value.

Now trading around 16, the stock is up 133% from a year ago.

Boosted Earnings

Keeley also likes Danielson's recent, industrial-related developments. On Feb. 1 the firm said it would buy American Ref-Fuel Holdings, which runs waste-to-energy plants in the Northeast.

"That combination more than doubles the firm's EBIDTA," Keeley said. "It will let them refinance some high-priced debt and do an equity financing. They've also got a $650 million tax loss carry forward, which means a certain portion of their income will not be subject to federal income taxes."

The stock is up 96% since Jan. 31.