

# Kiplinger's

PERSONAL FINANCE

**INSIDER INTERVIEW** | John Keeley  
produces terrific results by looking where  
others don't. *By Manuel Schiffres*

# SPIN(OFF) doctor

**T**WO NUMBERS IMMEDIATELY stand out when you examine Keeley Small Cap Value fund: 19% and \$277 million. The former is the fund's annualized rate of return over the past decade; the latter is its size. What's puzzling is how a fund that has been so good for so long has remained so small and little known. To put its performance in context, the fund's ten-year return ranks 17th among all stock funds. Its gains are nearly four percentage points per year better than the average of all funds that invest in small, undervalued companies and more than six points per year better than the average of all funds that invest in stocks of small companies.

One explanation for the fund's relative obscurity is that it levies a sales charge, of up to 4.5%, which turns off investors who pick their own funds. The other reason may be manager John Keeley's unusual style, which sets him apart from most bargain hunters. Keeley, 64, invests in niches that most other funds ignore: orphan companies that have been spun off by their parents, financial institutions that are converting from mutual to public ownership and companies that have emerged from bankruptcy.

To learn more about Keeley's style (and how it could improve your own investing results), we trekked to his office, directly across from the Chicago Board of Trade.

● In running Keeley Small Cap Value, John Keeley treads in areas that few other fund managers dare to go.



**KIPLINGER'S: Your fund's overall theme is companies that are restructuring. Explain what this entails.**

**KEELEY:** We look at spinoffs, savings and loans and insurance companies that are converting from mutual ownership to public ownership, stocks selling for below book value [assets minus liabilities], companies emerging from bankruptcy, and utilities that have gone astray. The common element among the companies is that there's usually something a little bit wrong with them. But the problems are fixable, and they allow you to buy the stocks at favorable prices.

**Spinoffs represent the biggest part of your strategy, correct?** Yes. They're about 40% of the fund.

**What makes them so attractive?**

First, a spinoff is new to the market. Typically, a company has a division that it can't sell, so it decides to spin off the division to shareholders. What makes a spinoff especially interesting is that the company doing the spinoff is usually a large company and is in a market index, and there's a lot of money in index funds. When the spinoff takes place, index fund managers must sell the new company because it is not in the index. The extra selling pressure causes the stock price to fall and makes the spinoff more attractive.

**What's a good example of this phenomenon?** Let's take Neenah Paper (symbol NP). It was just spun off from Kimberly-Clark (KMB), which makes Kleenex, Huggies diapers and other paper products. Kimberly-Clark is in Standard & Poor's 500-stock index. So

if you manage an S&P 500 index fund and you get Neenah in a spinoff, you have to kick it out of the portfolio. That puts pressure on the share price. On top of that, there is usually no analyst coverage on the new company—nothing to get people excited about it.

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**How are spinoffs priced?**

By whoever wants to make a market for them. It just happens. It's whatever the traffic will bear that day.

**Presumably, you don't want to buy right away because there's going to be selling pressure on the stock.** I try

to buy a spinoff over a three-month period because you don't know when these guys will let loose with the stock.

**Who do you mean by "these guys?"**

The portfolio managers who'd be selling the stock. You have about three months to do your homework. So you go through the S-10, which is like a prospectus without any pictures, and figure out if it's a good business and then try to get some framework as to what kind of price you want to pay. Then you sit around and see if the stock trades within your parameters.

**Is there a good source of information on spinoffs?** We use a firm in New York City called Horizon Research Services. But we've been doing it for so long that we know where to look. [Horizon's services are not available to the general public.]

**What are some spinoffs you like?**

About a year ago, BankAtlantic (BBX), a Florida thrift, spun off Levitt (LEV), the homebuilder. This is the company that built Levittown, on New York's Long Island, after World War II. But now most of its properties are in Florida. Another interesting one is MoneyGram (MGI), which was spun off last year by Viad (VVI).

**What does MoneyGram do?** It provides global payment services. It's a way for you to send money to your relatives in Istanbul.

**And you like Neenah, too?** Yes. It is in the fine-paper and pulp businesses, but mostly in pulp. The profit margins on pulp aren't as good as the margins on fine papers. The thinking is that, over time, Neenah will use its cash flow to buy other fine-paper businesses and reduce its dependency on the pulp business. The stock, which is now \$32, could be worth in the \$50s to \$60s in three years.

**Can you be a bit more precise in what you look for before you invest in a spinoff?** We look at the record.

For a spinoff not to be taxed by the government, it's got to have at least a five-year history within the parent company. We look at the management. We can ask some Wall Street people who've followed the parent company, "Was this a good division?" We look to see if the spinoff is cheap compared with its peers. We want good cash flow. Also, we invest only when the parent has spun off 100% of the division—it has to spin off at least 80%—because we want the management of the new company to be completely free of the parent. And as long as the companies are in good businesses, the stocks usually work out well.

**Is investing in a spinoff as close as you get to a layup in the stock market?** Well, there can be some bad ones.

There have been some in the technology and medical areas that haven't worked out. In general, we don't invest in technology and medical stocks because we don't understand them and because the life cycles of those kinds of companies tend to be shorter than our desired holding period of three years.

**Let's talk about S&L conversions.**

They have long been a mainstay of the fund. The one we bought most recently

is NewAlliance Bancshares (NAL). It's got a book value of about \$12 a share, and the stock's about \$15. And there's another one, BankFinancial, in Olympia Fields, Ill., coming out soon.

**Why do S&Ls undertake these conversions?** It's not just thrifts. You've got insurance companies converting, and now you're starting to see credit unions convert. You've got a situation in which the managers have toiled all their life for little, and conversion gives them a way to unlock the value of the thrift's shares. They usually get taken care of pretty well. Typically, book value is \$13 or \$14 a share, the stocks are priced at \$10, and they start trading at \$12. The passbook holders, the depositors and the people who have loans at the thrift have the first right to buy the shares at \$10. They are usually not stock-market guys, so they're in at \$10, out at \$12, and they think they've just died and gone to heaven. But we're in there buying because usually after a period of time, the company will start buying back stock and paying a dividend. And one study found that 70% of the companies that convert get taken over at a premium price within three years, typically at two to 2.25 times book value.

**So, after the firm converts, book value continues to grow?** Yes. Because the thrift is earning money and buying back its stock.

**And then some big bank comes along and buys the company at a premium to book value. Sounds like a slam dunk.** It is. And you're going to ask, "Why doesn't everybody do this?" I don't know.

**How do you find out about these conversions?** There's a firm in Charlottesville, Va., called SNL Financial, that tracks them. Some brokers, including Ryan Beck, also follow them. [SNL offers several publications that deal with thrift conversions. The least

costly is \$495 a year. For details, call 434-977-1600 or visit [www.snl.com](http://www.snl.com).]

**How often does a thrift convert at \$10, then sink to \$6 or \$5?** Not often. You want to stay away from the really small ones because nobody cares. Better to invest in something with at least a half billion in assets.

**Finding stocks below book value seems simple enough. How do you analyze them?** I look at the numbers, then try to verify whether the story makes sense. I want to make sure that it's a good business, that the company is in good shape and that there's some catalyst that will make the stock go up.

**You've often mentioned Providence & Worcester Railroad (PWX) as an example.** My perennial favorite. It was incorporated when Lincoln was president. It owns 650 miles of contiguous railroad in New England and New York. The stock's about \$13, and the book value is \$15. The land has been on the books since the company was incorporated, so the book value is probably understated. It's owned primarily by a couple of older folks. [The chairman, Robert Eder, and the president, Orville Harrold, are both 71.]

**How has the stock done for you?** I bought it about eight years ago, and it's still cheap.

**Does it need a catalyst?** Yes. I think that at some point the controlling shareholders will sell the company.

**What about your post-bankruptcy plays?** Typically, companies file for bankruptcy because they do something stupid and they pay for it with a lot of debt. A couple we own are Joy Global (JOYG), a mining-equipment company that used to be called Harnischfeger and had leveraged itself to the eyeballs, and Consecro (CNO), a life-insurance company. Consecro got into trouble when it overpaid to buy Greentree Finance, which made mobile-home loans. The stock's at \$20, just around book value. Consecro is earning about \$1.70 per share, and it has \$6.5 billion in tax-loss carryforwards, which has to be worth something to somebody. The IRS still has to rule on whether Consecro can use all of those loss carryforwards.

**What about utilities?** This is a fairly new theme. The idea of investing in some utilities that got into trouble when deregulation came along seemed to fit with the other things we do. Some examples of the stocks we bought are Allegheny Energy (AYE), CMS Energy (CMS) and Westar (WR).

**On another matter, do you think your fund would be bigger now if you had gone the no-load route?** When I started the fund, I had no distribution, so I went to the brokerage community and put a load on. If you use an adviser, you can buy the fund without a commission. But if I went no-load now, I feel I would be disloyal to the people who helped us get started.

**Sounds as if you have strong convictions on this subject.** It's a matter of wanting to go home with the one who brought you to the dance. **K**  
—*Research:* **CHRISTINE M. VARNER**

**TOP TEN** Keeley Small Cap

isted below are the biggest stock holdings in Keeley Small Cap Value as of January 3.

STOCK	% OF ASSETS
Texas Industries	1.2%
McDermott International	1.0
AK Steel Holding	1.0
Levitt Corp.	1.0
Bucyrus International	1.0
Walter Industries	1.0
Amerco	1.0
KFX	1.0
Dillard's	1.0
General Cable Corp.	1.0