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Clockwise from top left, James Clark, Harry Burn, John DeGulis, T. Gibbs Kane

Gary Spector for *Barron's*

Talking With Sound Shore Management

Value Amid the Storm

By Vito J. Racanelli

WHEN SOUND SHORE MANAGEMENT MADE ITS ANTEDILUVIAN move to Greenwich, Conn., from lower Manhattan way back in 1982, clients and colleagues "thought we were crazy," laughs Harry Burn, who along with T. Gibbs Kane founded the investment firm 30 years ago. Long before that quiet Connecticut suburb morphed into today's tony financial hub, the two saw its possibilities.

The move to "the sticks" was consistent with the money managers' focus on a contrarian value-investment strategy. "Rather than own what everyone else loves, we try to buy things that are on sale and sell things people are clamoring to own," says Burn. That approach has served 17-person-strong Sound Shore well. With nearly $7 billion under management, it has built a long record of outperformance by picking well-known stocks with large stock-market values.

As an independent fund manager with a stable management team, one strategy, a low 0.92% expense ratio and no load, Sound Shore is an increasingly rare animal. Though down in the 12 months ended Sept. 30, the **Sound Shore** Fund (ticker: SSHFX) has outpaced the S&P 500 over just about any period measured, no small feat in the past 12 months. It's up an annualized 11.2%, 10.4% and 6.9% for the 20, 15 and 10 years ended Sept. 30, respectively, versus 10%, 8.4% and 3.1% for the S&P. Perhaps it's no surprise, then, that 60% of its clients have been with Sound Shore for 10 years or more.

While a value shop, "we're not interested in significant turnarounds," Burn says pointedly. Sound Shore's three portfolio managers and four analysts look at businesses with a history of quantifiable margins, balance sheets, strategy and growth rates, "as opposed to problematic companies. That's why we've not been in a big rush to go back into financials, just because the [stocks] are down." Indeed, Burn notes, the fund has benefited from underweighting financial stocks over the past 18 months or so, and avoiding the spectacular blow-ups "like Lehman, Fannie Mae, Freddie Mac and AIG."

Sound Shore portfolio manager John DeGulis, whose father was a money manager, adds that financials in 2006 were the "classic" example of a value trap. They looked cheap, with a price-earnings ratio of 10 times or so, but at the time returns

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on equity and leverage were at all-time highs, while price-to-book ratios were "at best fair."

DeGulis, 42, a 20-year industry veteran with 13 years at Sound Shore, says its investment process begins by sifting through the roughly 1,250 stocks that have a market capitalization of more than $3 billion. The list is whittled to around 250 by screening for shares that are in the market's lowest price-to-earnings quintile and sporting P/Es at lows relative to the stock's history.

Afterward comes a "value check" to weed out shares that aren't really bargains, notes James Clark, 46, a former head of equity research at Credit Suisse First Boston. An example, Clark says, would be a coal stock trading at just six times earnings when coal prices and returns on capital are peaking, and the issuer is outspending cash flow because it's hell-bent for growth.

The screening trims the universe to about 80 to 100 names. From there, says DeGulis, "we do the math . . . . We don't take Wall Street analyst numbers or what the management team tells you for granted." Sound Shore models the income statement, cash flows and balance sheet, searching for an earnings driver for the next 18 months.

A largely equal-weighted portfolio of 40 names is culled from this list. Sound Shore looks for solid companies that the Street has lost interest in, but that have good earnings power and could surprise investors positively over one to two years.

The firm doesn't get emotional about its winners. "When we reach the target, it is a candidate for sale, and typically they get sold," says DeGulis. "A typical holding is about three years," adds Clark, who grew up talking stocks at the dinner table with his father, who was in the brokerage business.

The current maelstrom presents an opportunity for Sound Shore, whose annual portfolio turnover is a modest 33%. Says co-founder T. Gibbs Kane: "Our job is to stay in the duck blind. When the weather is inclement, you tend to have more ducks. When everybody else is in the lodge, staying warm and dry, the opportunities will be better for us."

Among some of Sound Shore's current holdings are **Cardinal Health** (CAH), **Royal Dutch Shell** (RDSA), **Pfizer** (PFE), **Credit Suisse Group** (CS) and **Aon** (AOC).

Credit Suisse should emerge as a winner from the capital-markets crisis, DeGulis maintains, because of the capacity that's been taken out of investment banking and private-wealth management businesses. And it has a strong balance sheet and a management team battle-tested by the Swiss bank's own restructuring in 2000-2002.

Since the end of 2006, Credit Suisse has sold some assets and hedged others to cut exposure to toxic investments. It's positioned to take wealth-management share from wounded rival **UBS** (UBS), he says. Its private-banking business, DeGulis argues, "alone is worth the entire stock price of 37." DeGulis thinks it's worth over 70.

As for Royal Dutch, Clark says, it's the only major integrated oil company that probably will have meaningful reserve and production growth over the next three or four years, after having positioned itself in unconventional hydrocarbons, like liquefied natural gas—now 15% of its business and soon to be 20%. Royal Dutch also is big in other growing plays, like the heavy oil reserves in Canada, and has a "nice shale natural-gas play" in the U.S. Royal Dutch, which sports a 6% dividend yield and a solid balance sheet, is worth about 75, using a normalized multiple of 10 times an EPS of $7.50 in 2009, says Clark.

Another pick, Pfizer, is clearly out of favor, in part because its blockbuster anticholesterol drug, Lipitor, goes off-patent in 2011. (Lipitor will produce about $1 of the company's $2.40 earnings per share in 2008.) But, DeGulis says, the market is valuing the rest of Pfizer, with a 7% dividend yield, at 11 times on non-Lipitor earnings, "and we think that those earnings will grow." Given what's happened in the world, cash and the value of a powerful balance sheet has just gone up immeasurably, he adds, and Pfizer has $25 billion in cash—$10 billion net of debt. Sound Shore's target for the stock is the high 20s; it's recently been around 18.

Another holding, Aon, with its arch rival, **Marsh & McLennan** (MMC), forms what is almost a duopoly in insurance brokering for the world's largest 1,000 corporations. Says DeGulis: "This is a business that is not capital-intensive, so returns are high." Aon trades at 13 times expected 2009 EPS, is taking market share, has a balance sheet that is a fortress, and is buying stock back. "There's cyclical risk, but at 13 times we like Aon," he says, and think it's worth about 55, versus a recent 38.

Cardinal Health is one of a handful of restructuring candidates in the fund's portfolio. Growth has slowed in its branded and generic drug-distribution business, but the industry has consolidated, with only two other major players, **AmerisourceBergen** (ABC) and **McKesson** (MCK). Cardinal has restructured the drug operations, which are improving. "We think the drug-distribution earnings are stabilizing in the next six months, and will begin to grow again. The other half of the business, medical products, has been growing and will continue" to do so at double-digits.

Cardinal Health recently said it would split its drug-distribution and medical-products units. "It's undervalued, and the two parts are worth more than the whole," says DeGulis. Sound Shore has a mid-60s target price on the stock, recently near 44.

On the bear side, he observes, Sound Shore is wary of companies that provide "any consumer item that requires a loan for purchase: autos, appliances, homes. We think the unwind there is multiyear." ■

Sound Shore Management
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	Total Returns*		
	1-Yr	3-Yr	5-Yr
Sound Shore	-17.9%	0.8%	7.4%
S&P 500	-22.0%	0.2%	5.2%

Top 10 Holdings	Ticker	% Of Portfolio**
CIGNA	CI	3.7%
Kimberly-Clark	KMB	3.6
Texas Instruments	TXN	3.4
Flextronics Int'l	FLEX	3.3
Time Warner	TWX	3.3
Comcast, Class A	CMCSA	3.3
General Electric	GE	3.3
Royal Dutch Shell	RDSA	3.2
AES	AES	3.2
Boston Scientific	BSX	3.2
Total:		33.5

*As of 9/30. 3-year and 5-year annualized. **As of 8/31.
Sources: Bloomberg; Sound Shore