Sound Shore SSHFX

Trying to turn company problems into fund successes.

08-15-13 | by Gregg Wolper

Sound Shore's managers try to hold down risk but are willing to step in when trouble creates opportunity.

This fund's leaders aren't eager to tempt fate. Although they own just 40 or so stocks, they spread out their investments; no single company gets more than 3.5% of assets. And they shy away from small caps. However, when a company that they feel has strong fundamentals encounters a problem that hits its share price, that piques their interest.

One recent example was Hospira HSP, the health-care firm that had to curtail production at one of its plants owing to FDA concerns. Its share price fell roughly in half in late 2011. Managers Harry Burn, Gibb Kane, and John DeGulis didn't buy immediately, as they often do. Instead they waited to see signs of improvement. Even though waiting could mean missing out on some of the gain from recovery, they explain that they preferred to see solid evidence to support their optimism, such as rising production rates at the plant in question. They bought in early 2013, and the stock has jumped since then. With embattled insurer American International Group AIG, they waited several years to jump in, until the U.S. government was finally about to relinquish its control. They bought in 2012's third quarter, and though they missed out on earlier gains, they still have received quite a climb so far.

Sometimes the payoff takes longer to arrive, as with Bank of America BAC and Citigroup C. Those stocks partly accounted for this fund's subpar returns in 2010 and 2011, but they helped power a top-decile return in 2012 and a similar success thus far in 2013.

These aren't isolated instances. The fund's 10-year ranking through Aug. 12, 2013, is in the 30th percentile of the large-value category, and its 15-year return lands in the 25th percentile. From the fund's 1985 inception through Aug. 12 its annualized return has topped the S&P 500 Index by 30 basis points and the large-value and large-blend categories by more than 1.5 points apiece. (Its portfolio has spent some time in both sections of Morningstar's Style Box.) This is not the most daring value player, but it's a solid choice.

Process Pillar: ⊕ Positive | Gregg Wolper 08/15/2013

The managers look for stocks that have solid fundamentals and encouraging prospects but that are out of favor for one reason or another. To find candidates, they and their analysts screen mid- and large-cap equities from the United States and abroad to identify stocks trading at substantial discounts to their historic price multiples. Once the team has narrowed the list, it evaluates a firm's competitive position by speaking with company management, competitors, and customers. The team then prepares detailed financial and valuation models. The result is a portfolio of 40 or so mid- and large-cap companies. Even with such a compact portfolio, though, the fund is not overly concentrated in individual companies, as many focused funds are; typically no stock gets more than 3.5% of assets. The managers' willingness to buy companies about which most investors have doubts means the fund's stocks sometimes fall further before their value is recognized, and sometimes don't recover. While foreign stocks often appear here, their number usually is limited to a handful of names. The managers have a long-term perspective but will sell when a stock appreciates to their target price or the story changes for the worse, so the annual turnover rate has been around the 60% range in recent years. That is close to the current large-value average, rather than at more-minimal levels.

The managers have stuck with their long-held plays in 2013, but with a few more-recent additions. On the whole, the portfolio is still heavy in the health-care sector, with a 26% stake that's roughly double the large-value category average. Some of the holdings in this group are multinational pharmaceutical giants, such as Sanofi SNY, Pfizer PFE, Novartis NVS, and Merck MRK (a 2013 addition). The managers bought most of these firms when doubts about their new drug pipelines had depressed their shares. Now their prices have risen as such fears have lessened, but the managers still consider them undervalued, with leaner structures and some promising drugs. Other health-care holdings include WellPoint WLP, added in late 2012, whose revamped management team gives them confidence and which they think will be well-placed to thrive under health-care reform. Another area of focus is financials, where the fund has holdings ranging

Morningstar's Take SSHFX

Morningstar Rating	★★★
Morningstar Analyst Rating	Silver
Morningstar Pillars	
Process	⊕ Positive
Performance	⊕ Positive
People	⊕ Positive
Parent	⊕ Positive

Fund Performance SSHFX

Year	Total Return (%)	+/–Category
2012	19.32	4.75
2011	-6.18	-5.43
2010	12.13	-1.53

Data through 12-31-12

from big banks (Citigroup C and Bank of America BAC) to insurance (American International Group AIG and Aon AON), to other actors (Charles Schwab SCHW and Capital One COF). They have just a slight overweighting in financials, though, for that's a popular sector among most large-value funds. Overall, the portfolio sits right on the border between large-value and large-blend, reflecting the managers' tendency to buy companies with some issues, but usually not diving in until some reason for optimism is evident.

Performance Pillar: Positive | Gregg Wolper 08/14/2013
After subpar years in 2010 and 2011, this fund has been hot, landing in the top decile of the large-value category in 2012 and for 2013 through Aug. 12. This strong run has boosted the fund's long-term performance. Its 10-year ranking through Aug. 12, 2013, is in the 30th percentile of the large-value category, and for the 15-year period it lands in the 25th percentile. And with this fund, long term really means long term. From the fund's inception in 1985 through Aug. 12 (with two of the three current managers in charge the whole time), it has posted an annualized return of 11.2% per year, topping the S&P 500 Index by 30 basis points and the large-value and large-blend categories by more than 1.5 points apiece. (Its portfolio has spent some time in both sections of the Morningstar Style Box.)

The fund's woes in 2010 and 2011 were caused partly by Citigroup C, Bank of America BAC, and General Motors GM, whose problems stemming from the financial crisis continued. But sticking with them paid off as they helped the fund rebound in 2012. Its 19.3% gain that year topped the large-value average by nearly 5 percentage points and the S&P 500 Index by more than 3. It's doing even better than that thus far in 2013.

Investors should not choose this fund for a smooth ride, however. Its Morningstar Risk ratings and other measures of volatility are in general slightly worse than the norm.

People Pillar: Positive | Gregg Wolper 08/15/2013
Shareholders here get an extraordinary amount of experience and continuity. The managers of Sound Shore Fund have been guiding this portfolio, using the same strategy, for decades. Managers Harry Burn and Gibbs Kane founded advisor Sound Shore Management in 1978 (Burn has a 45% ownership stake, Kane has a 30% stake), and they have led Sound Shore Fund since its inception in May 1985. The private accounts run by the advisor, which amounted to 54% of the firm's $5.4 billion of assets under management as of June 30, 2013, use the same approach as the fund; the firm does not run any other strategies. Burn and Kane were the mutual fund's sole managers until 2003, when John DeGulis, who had worked with them as an analyst since 1995, was named a comanager of the fund. Burn, Kane, and DeGulis all have more than $1 million of their own money invested in Sound Shore, a commitment that helps align their interests with the fund's shareholders. (The firm's profit-sharing plan also is invested in the fund.) This trio works with four in-house analysts who joined the team between 2003 and 2008. All of the analysts and managers are based in the Sound Shore office in Connecticut. Most stocks are researched by teams of two, typically one manager and one analyst. The firm does little to no marketing of the fund and has come out with no other mutual funds.

Parent Pillar: Positive | Gregg Wolper 10/03/2011
This firm has some attributes that many other fund companies would be wise to emulate, in part if not in whole. Sound Shore Management was founded in 1978 by Harry Burn and Gibbs Kane, two of the portfolio managers of Sound Shore SSHFX, and it is still owned and run by them. The firm offers just one mutual fund, and its only other business is running separate accounts in the same style. The firm doesn't do any advertising and does very little marketing. The fund managers spend only minimal time on any sort of marketing activity.

The firm had $5.2 billion under management as of Sept. 30, 2011, with slightly more than half of that in separate accounts. Its managers and analysts stick around; there has been no manager turnover—Burn, Kane, and John DeGulis, who has been with the firm since the 1990s, are the three managers—and little change among the analyst staff, which now numbers four. The three managers each invest more than $1 million in fund shares, demonstrating industry-leading skin in the game.

The one area that could stand improvement is shareholder communications. Shareholder reports are candid about specific holdings, but they are not as lengthy or detailed as they could be, especially when compared with the best reports from small shops committed to a distinctive style, such as Third Avenue.

Price Pillar: Neutral | Gregg Wolper 08/15/2013
Sound Shore has only one share class, which has no load attached to it. Its expense ratio of 0.94% as of the December 2012 annual report is in the average range for large-cap domestic-stock funds with no sales charge, so the fund gets a Neutral rating for Price even though that expense ratio is a bit below the group's median.

For each fund with at least a three-year history, Morningstar calculates a Morningstar Rating TM based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a fund's monthly performance (including the effects of sales charges, loads, and redemption fees), placing more emphasis on downward variations and rewarding consistent performance. The top 10% of funds in each category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars and the bottom 10% receive 1 star. (Each share class is counted as a fraction of one fund within this scale and rated separately, which may cause slight variations in the distribution percentages.) The Overall Morningstar Rating for a fund is derived from a weighted-average of the performance figures associated with its three-, five- and ten-year (if applicable) Morningstar Rating metrics. As of 9/30/13, Sound Shore was rated against the following numbers of U.S.-domiciled Large Value funds over the following time periods: 1043 funds in the last three years, 926 funds in the last five years, and 608 funds in the last ten years. With respect to these Large Value funds, Sound Shore received a Morningstar Rating of 4, 3, 3 stars for the three, five- and ten-year periods, respectively. **Past performance is no guarantee of future results.**

Morningstar Analyst Rating

The Morningstar Analyst Rating is not a credit or risk rating. It is a subjective evaluation performed by the mutual fund analysts of Morningstar, Inc. Morningstar evaluates funds based on five key pillars, which are process, performance, people, parent, and price. Morningstar's analysts use this five pillar evaluation to identify funds they believe are more likely to outperform over the long term on a risk-adjusted basis. Analysts consider quantitative and qualitative factors in their research, and the weighting of each pillar may vary. The Analyst Rating ultimately reflects the analyst's overall assessment and is overseen by Morningstar's Analyst Rating Committee. The approach serves not as a formula but as a framework to ensure consistency across Morningstar's global coverage universe.

The Analyst Rating scale ranges from Gold to Negative, with Gold being the highest rating and Negative being the lowest rating. A fund with a "Gold" rating distinguishes itself across the five pillars and has garnered the analysts' highest level of conviction. A fund with a 'Silver' rating has notable advantages across several, but perhaps not all, of the five pillars-strengths that give the analysts a high level of conviction. A "Bronze"-rated fund has advantages that outweigh the disadvantages across the five pillars, with sufficient level of analyst conviction to warrant a positive rating. A fund with a 'Neutral' rating isn't seriously flawed across the five pillars, nor does it distinguish itself very positively. A "Negative" rated fund is flawed in at least one if not more pillars and is considered an inferior offering to its peers. Analyst Ratings are reevaluated at least every 14 months.

For more detailed information about Morningstar's Analyst Rating, including its methodology, please go to http://corporate.morningstar.com/us/documents/MethodologyDocuments/AnalystRatingforFundsMethodology.pdf.

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