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# LOUIS RUKEYSER'S MUTUAL FUNDS

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## THE RUKEYSER INTERVIEW

# Passing the Torch

In the world according to Rukeyser, fund manager changes are rarely a good thing. And when the departing manager is Bill Fries, longtime manager of **Thornburg Value** (TVAFX) and one-time winner of *Morningstar's* International Manager of the Year award, you can expect a lot of folks to head for the door. But there's little cause for concern in this case: Fries leaves his former charge in the hands of co-managers Edward Maran and Connor Browne, both of whom worked closely with him for almost four years and don't plan any strategic changes. We spoke with Ed Maran about his approach to portfolio construction and his favorite names for 2010.

—Benjamin Shepherd



I understand that you will continue to follow a tripartite approach to portfolio construction that groups holdings into three baskets. Would you mind elaborating on this process?

The first basket is basic value, which includes companies that produce commodity-like products. If you think about banks, consumers don't really care about where they get their loan; most people just worry about the interest rate and terms. The same logic holds true for gasoline—consumers just care about price and convenience. If you're competing on price and service, then your business will tend to be a lot more cyclical than that of a company which has proprietary brands, patents, or some other protection.

When we look at a company that operates in steel or another cyclical industry, we'll compare the valuation of and prospects for that stock to oil companies, financials and other names in the basic-value universe.

We also hold some names that generate consistent earnings, even though they typically trade at higher valuations. Consistent earners are at the opposite extreme of the basic-value basket. They tend to have strong brands or patent protection—

something that enables them to grow earnings predictably each year.

An example would be **Comcast** (NSDQ: CMCSK), which has an established subscriber base—in that case, the question is how many subscribers it will add in the coming year. This business model differs widely from a company that has to drum up new customers for every sale.

The third basket, which we think is unique for a value fund, focuses on what we call emerging franchises. Here we're looking for companies with the potential to dominate a particular niche or segment of the market that has far better growth prospects than the overall economy.

An example of an emerging franchise would be **Varian Medical Services** (NYSE: VAR), the leader in radiation oncology equipment. The company's market share exceeds 50 percent, which enables the firm to spend more on research and development than all of its competitors combined. At the same time, the market for radiation oncology should grow as the population ages and the technology becomes more prevalent abroad.

Do you expect the gains of the last nine months to extend into 2010?

We are bottom-up investors, so our investment decisions aren't necessarily driven by economic or market forecasts. That being said, we are relatively optimistic about corporate earnings; the US economy is emerging from recession, and monetary policy should remain relatively benign—the Federal Reserve likely will keep the target rate at or near zero percent because the prospects for consumer spending remain weak.

It also will take time for the banks to provide the financing that the economy needs to grow.

Are any sectors of particular interest from a value prospective?

Financials are still undervalued, even with the rally. If you look at bank stocks, they're trading at very low multiples of book value compared to where they have historically traded.

One that we own, **US Bancorp** (NYSE: USB), has typically traded at over 2.5 times book value and right now trades at around 1.8 times. Even a reversion to the historical norm would provide good upside—and US Bancorp is one of the stronger banks, so it doesn't trade at as large a discount as some names.

Investors are still pricing in a lot of

## FOUR BASIC VALUES AND ONE CONSISTENT EARNER

*Alone amongst major oil companies and insurance outfits which Thornburg classifies as basic value plays, Microsoft is considered a consistent earner based on its ubiquitous brand.*

Security (Exchange: Symbol)	Recent Price*	Recent Yield*	Price to Earnings#	Price to Book	Price to Sales#	Debt to Equity
Microsoft Corp (NSDQ: MSFT)	\$29.60	1.8%	19.2	6.3	4.6	0.1
Ace Ltd (NYSE: ACE)	48.58	0	10.1	0.9	1.2	0.2
ConocoPhillips (NYSE: COP)	50.21	4	12.9	1.2	0.5	0.5
Swiss Re (SIX: RUKN)	47.34	0	N/A	0.8	0.6	0.9
Marathon Oil Corp (NYSE: MRO)	30.91	3.2	20.3	1	0.5	0.4

\*As of 12/17/09, close. #Trailing twelve months. Source: Morningstar, Thornburg Value

risk based on the belief that banks' profitability will be reduced because the government will force them to hold more capital and that less leverage will lower return on equity. I expect that the higher net interest margins which accrue from an improved competitive environment will more than offset a reduction in leverage.

Many of the entities that were providing mortgages, credit cards, business leases and commercial credit at the height of the boom have been wiped out. Without that competition, banks should be able to grow their loan books and charge higher interest rates. This favorable environment should hold for a number of years.

Right now there's little loan demand because the economy continues to struggle; this weakness blunts the impact of an improved competitive environment. Because many banks need to rebuild capital, they're investing in Treasuries and other low-risk securities—a strategy that weighs on net interest margins.

But when the economy recovers two factors will enter the picture. Increased demand will enable banks to grow their loan books, and the improved risk appetites of the banks themselves will allow them to shift into higher yielding assets like loans. Such a development would have a huge impact on profitability.

**Many analysts have identified commercial real estate (CRE) as the next shoe to drop for the banks. Do you think CRE poses a major threat?**

This exposure will challenge some institutions more than others, but in general the risk associated with CRE is a lot less than it was with residential real estate.

If businesses occupying a building are in operation, they're less likely to default just because the value of the building goes down.

Most buildings are also professionally managed; a lot of the problems we saw with defaulting homeowners—who stopped doing maintenance and, in some cases, actually took stuff from the home—wouldn't happen in commercial real estate. The quality of the building will remain intact; you won't see the value of the building going down because the asset is being physically destroyed.

**You have a fair amount of foreign exposure in your portfolio. What are your favorite names right now?**

**China Mobile** (NYSE: CHL) is trading at an attractive valuation relative to US telecom companies. And that market is still underpenetrated and has a lot of room for growth.

Another foreign stock that we hold is **Gazprom** (OTC: OGPZY). It has attractive assets that you won't find anywhere else. The company is the

largest owner of natural gas in the world, and Europe is literally dependent upon this company and its gas to be able to heat its homes in the winter. If anybody in Russia finds natural gas and needs to transport it, they have to pay Gazprom because it's the only company with such a pipeline.

And then there's **Tokyo Steel** (JP: 5423), which was an unusual value opportunity. The firm just built a steel plant that started to operate in November. It also has a huge amount of cash on the balance sheet and no debt. The company has a market cap of JPY 158 billion and almost JPY 75 billion in cash.

**Do you normally avoid companies with heavy debt loads?**

If we can get a company that has no debt and the same prospects for earnings growth as a company that has leverage, we prefer the debt-free name because it has the strength to withstand difficult times and the ability to deploy that cash to grow when times are good—cash on the balance sheet gives a company options.

**What's your best advice for investors over the next year?**

It's important to stay invested and know what you own. If you thoroughly understand the companies you're invested in, you have a substantial advantage. ▲

The views expressed by Ed Maran reflect his professional opinions and are subject to change. Securities, sectors, and industries mentioned are presented to illustrate companies, sectors, and industries in which the funds have invested. Portfolio holdings are subject to change daily. Under no circumstances does the information contained within represent a recommendation to buy or sell securities.

Thornburg Value Fund Top 10 Holdings, as of 11/30/09: 1) Microsoft Corp., 3.7%; 2) Ace Ltd., 3.3%; 3) ConocoPhillips, 3.2%; 4) Swiss Re, 3.1%; 5) Marathon Oil Corp., 3.1%; 5) Entergy Corp., 3.0%; 6) Dell, Inc., 2.9%; 7) Dish Network Corp., 2.8%; 9) Monsanto Co, 2.8%; 10) Thermo Fisher Scientific, Inc., 2.7%

Investments in the Fund carry risks, including possible loss of principal. Special risks may be associated with investments outside the United States, especially in emerging markets, including currency fluctuations, illiquidity and volatility. Investments in small capitalization companies may increase the risk of greater price fluctuations. Investments in the Fund are not FDIC insured, nor are they deposits of or guaranteed by a bank or any other entity.

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Price/Earnings ratio (P/E ratio) is a valuation ratio of a company's current share price compared to its per-share earnings. P/E equals a company's market value per share divided by earnings per share.

Price/Book ratio (P/B ratio) is a ratio used to compare a stock's market value to its book value. It is calculated by dividing the current closing price of the stock by the latest quarter's book value per share.

Price/Sales is the ratio of a stock's price to its sales. Price to sales is calculated by dividing a stock's current price by its sales per share.

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