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Meltdown Leaves Big Opportunity in Small Caps

Teton Advisors' Nicholas Galluccio says the market declines of 2008 and early 2009 wreaked havoc on efficient markets, and small-cap managers have the best hunting ground.

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Value investing has long been taught at Columbia Business School by Bruce Greenwald, a disciple of Columbia alumnus Benjamin Graham. At the other end of the spectrum are proponents of modern portfolio theory and efficient markets, academicians like Burton Malkiel of Princeton University and Eugene Fama of The University of Chicago. Through their research, both men have given credence to the belief that the history of stock-price movements contains no useful information that would enable an investor to consistently outperform a buy-and-hold strategy in managing a portfolio. Investors, they say, have done no better with the average mutual fund than they could have done by purchasing an index fund.

In essence, the efficient market thesis preaches that all that is known concerning the expected growth of a company's earnings and dividends, all of the favorable and unfavorable developments affecting the company that might be researched by the fundamental analyst, are already reflected in the price of the company's stock. Said another way: Fundamental analysis of publicly available information cannot uncover opportunities that enable a fund manager to consistently outperform an index fund. Market prices reflect the sum of all information.

These theories have become suspect with recent market declines that have wreaked havoc on efficient markets, causing broad-based distortions in prices across most asset classes, from high-yield and corporate bonds to emerging-market and domestic equities. Indiscriminate panic-selling and lack of liquidity have led to enormous disparities in market prices of securities, affording investors terrific bargains. While credit spreads versus U.S. Treasuries have narrowed and equity markets have rallied mightily, some 40%, from their March lows, financial markets remain constrained by economic headwinds and high unemployment.

Not surprisingly, corporations have little near-term profit visibility. Hence, investors must look through the valley to normalized earnings in analyzing equities. No matter—stocks are cheap and value investors should be salivating over the many bargains left in the wake of the bear market.

The magnitude of wealth destruction caused by the recent bear market has turned conventional thinking upside down. Over the previous nine months, equities have been pummeled by forced liquidations of hedge funds along with redemptions by institutional and retail investors succumbing to financial panic. For example, in the small cap fund that I manage (GAMCO Westwood SmallCap Equity WESCX), distortions were such that we were able to purchase stocks of companies selling at discounts to the net cash on their balance sheets. With global economies in deep recession and stock prices significantly below 2008 peak levels, the current environment affords investors one of the best risk-reward opportunities of the past 20 years. Nowhere are valuations cheaper than among small capitalization companies, hit hardest by liquidity conditions. There is no question that as you move up the liquidity spectrum, stocks become more efficiently priced. Conversely, as you move down in liquidity, there are greater inefficiencies. While equities encompassing all market capitalizations were impacted by the market meltdown, the volatility associated with the ascension of hedge funds and the massive contraction in financial services have exacerbated pricing disparities among small-cap equities.

Given unprecedented market volatility, it is not surprising to see certain stocks today turn over as much as 20 times a year. Twenty-five years ago, mutual fund portfolio turnover averaged 30%; today, it averages nearly 90%. And for hedge funds, portfolio turnover is many times greater. **Volatility equals greater inefficiency, which equals greater investment opportunity, which equals better overall return potential.**

Moreover, Wall Street sell-side research is becoming a casualty of the market's decline as the wave of consolidation sweeps across financial services. With multiple mergers, research departments are firing their most expensive or redundant analysts and forcing others to drop small-cap coverage in favor of global leaders in their research universe. Brokerage house mergers are sharply reducing company coverage: Bear Stearns into JPMorgan, Merrill Lynch into Bank of America, Smith Barney into Morgan Stanley, AG Edwards into Wachovia, now into Wells Fargo. It's estimated that Wall Street coverage has been reduced by nearly 25%, according to Factset Research Systems. And small companies often suffer most from dropped coverage with their stocks sustaining less trading liquidity. **Dropped research coverage should result in greater pricing inefficiencies, affording investors attractive valuations and the opportunity for significant appreciation potential especially in the thinly traded stocks of smaller companies.**

The New Normal Is Back to Basics

Just as one would expect from a diehard active small-cap value manager, such as myself, I firmly believe old fashioned, bottom-up, research-driven stock-picking will prevail in its challenge against modern portfolio theory, especially following this recent bear market. As a result, **value investors have been handed the best opportunity to beat index funds over the next market recovery cycle. Because small caps are especially cheap, it's a good time for active managers to sift through the bear market rubble and to refocus on company fundamentals: balance sheets, earnings, cash flow, and enterprise values.** There are plenty of cheap, small-cap companies in technology, energy, health care, industrials, and financials that will either grow into mid-caps or become acquisition targets when deal activity revives. Call it pollyannaish, but I was taught to kick the tires, visit with company managements, and scour Securities and Exchange Commission filings as a foundation to the investment process.

As we look through the valley to the next market recovery cycle, patient investors stand to reap windfall gains from today's depressed stock prices. **Small-cap managers generally have an inherently better chance at outperforming the overall market by taking advantage of inefficiencies in under-researched and misunderstood companies.** While no one can claim absolute victory in the active versus passive debate, one thing is clear: The seismic change reshaping the investment landscape will leave its indelible mark for many years to come.

Provided by Teton Advisors.

Nicholas Galluccio is President and CEO of Teton Advisors, Inc. and Portfolio Manager of GAMCO Westwood SmallCap Equity (WESCX).

Important Disclosure Information

Nicholas F. Galluccio is the President and CEO of Teton Advisors, Inc., and the Portfolio Manager for The GAMCO Westwood SmallCap Equity Fund. Individual securities mentioned are not representative of the entire portfolio. The views expressed in this article reflect those of the Portfolio Manager only through June 30, 2009, and are subject to change at any time based on market and other conditions.

Stocks are subject to market, economic and business risks that cause their prices to fluctuate. Consequently, you can lose money by investing in the Fund.

Securities of smaller companies present greater risks than securities of larger, more established companies. The stocks of smaller companies may trade less frequently and experience more abrupt price movements than stocks of larger companies, therefore, investing in this sector involves special challenges.

Investors should carefully consider the investment objectives, risks, charges and expenses of the Fund before investing. The Prospectus contains more information about these and other matters. The Prospectus should be read carefully before investing.

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