



Built to Last

By Rob Wherry

Headquartered in an 87-year-old building designed to withstand any disaster, Croft-Leominster survives on a flow of contrarian ideas.

The four-and-one-half-story building at the corner of Water and South streets in Baltimore has stood the test of time for almost 90 years. The original structure featured a sturdy red-brick façade with 10-inch-thick walls in some places, eight-over-eight windows with stone sills, and a gabled slate roof. Even when it was built, its Colonial-style architecture was considered old-fashioned compared with the sleek new steel-and-concrete high-rises going up around the city. Nevertheless, Canton House, as it is called, still stands today much like it was when it was completed in 1923.

It's fitting, then, that this sturdy and unstylish structure is now home to an investment firm whose stock-picking strategy has avoided flashy investing trends while riding out much of the market's ups and downs during the past 20 years. Croft-Leominster is a family-run company that manages \$600 million across separately managed accounts and two mutual funds. Gordon Croft and his two sons, Kent and Russell, are traditional value investors who pride themselves on generating contrarian ideas.

"We want to keep a flow of ideas coming," Kent Croft says. "That is our singular focus."

While neighbors T. Rowe Price and Legg Mason run hundreds of billions of dollars from soaring towers along the city's famous Inner Harbor, Croft is content to keep a low profile. That's fine with shareholders, especially given the firm's track record. Croft Value CLVFX, the company's \$300 million flagship fund, has returned an average annual 3% during the trailing decade versus a 1.5% drop for the S&P 500. The fund is up 1 percentage

point on that same benchmark during the trailing 15 years.

“Why doesn’t Kent Croft have billions of dollars in the fund?” asks Adam Bold, founder of The Mutual Fund Store chain and a large shareholder who was attracted by the firm’s long-term track record. The only reason, he says, is “because nobody has heard of it.”

Family Reunion

Just three blocks separate Croft-Leominster and T. Rowe Price in downtown Baltimore, but the ties between the two firms are even closer. Gordon Croft was hired at T. Rowe in 1967 and spent 22 years at the company as an investment counselor, director, and fund manager. Croft became well-schooled in T. Rowe’s growth stock-picking strategy. But while he was there, he was also given freedom to explore investment ideas—at either end of the market-cap and style spectrum and located here or abroad. That approach can be seen in Croft Value—it is an all-cap fund that features domestic value stocks, but it has some growth and international names, too. And, ultimately, the independence T. Rowe gave him as a fund manager made it easier for Croft to open his own firm.

In the mid-1980s, Kent Croft was working in the equities department at Salomon Brothers. At the time, Salomon was run by John Gutfreund, the Wall Street legend later depicted in the Michael Lewis bestseller, *Liar’s Poker*. Although Croft avoided the fixed-income shenanigans that later plagued the company, he realized Salomon wasn’t a permanent home. He moved back to southern Maryland and worked on real estate deals for a year while living in a house a mile out in the woods. He and his father then hatched the idea for their own firm.

The Crofts opened Leominster, Inc. in 1989 with roughly \$500 million under management. (Leominster references a town in England where there is a Croft Castle. The family name was added several years later.) Half of that

money came from a single institutional account that followed Gordon Croft from T. Rowe, but that client soon pulled out its money when its board got spooked about using a small, unproven firm. As assets dropped to around \$100 million, the pair hunkered down managing separate accounts. They added two mutual funds in 1995, Croft Value and a companion fixed-income fund, Croft Income CLINX. A second son, Russell, became a fund manager in 2006, after several years at Gabelli & Co.

Generating Ideas

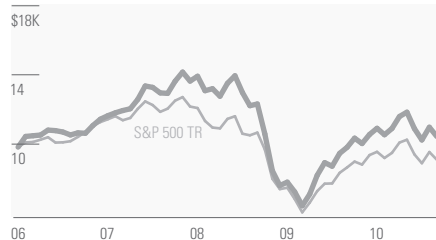
The underlying strategy that drives Croft Value starts with ideas. The Crofts will typically consider 1,000 investment ideas a year, generated by four to five in-house analysts, Wall Street, independent research houses, and a network of what the company calls “deep thinkers”—money managers, academics, or industry types that the team calls from time to time to trade insight.

Those ideas are then rigorously vetted. Team members at Croft will study traditional value benchmarks like price/earnings, price/book, cash flow, and what they call “assets on the ground.” They will compare each financial metric with those of peer companies, the category, or the broad market. There are no hard-and-fast rules about whether a stock has to be trading at a certain discount—although the team prefers to purchase shares at \$0.80 on the dollar or cheaper. Catalysts are also important, like surprise earnings or a new hit product. Ultimately, a watch list of 200 firms will lead to 80 fund holdings.

That strategy creates a portfolio that’s hard to pin down. Croft Value has 61% of its assets in mega- and large-cap stocks, 31% in medium-sized companies, and 8% in small- and micro-cap names. Familiar stocks like Philip Morris PM and Bank of America BAC sit alongside relative unknowns, such as top holding Petrobank Energy and Resources (a Canadian firm) and Dutch biotech outfit Qiagen QGEN.

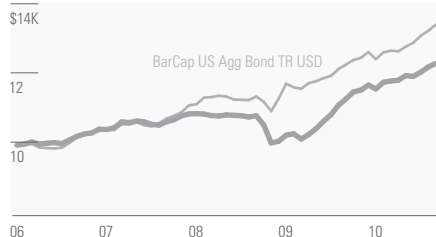


Croft Value CLVFX



Category	Expense Ratio (%)
Large Blend	1.32
Morningstar Rating	5-Yr Anl Total Rtn (%)
★★★★	1.92
Minimum Investment	5-Yr Anl TR % Rank Cat
\$2,000	6

Croft Income CLINX



Category	Expense Ratio (%)
Long-Term Bond	1.10
Morningstar Rating	5-Yr Anl Total Rtn (%)
★★	4.15
Minimum Investment	5-Yr Anl TR % Rank Cat
\$2,000	78

Data through Aug. 31, 2010

Why doesn't Kent Croft have billions of dollars in the fund? Because nobody has heard of it.

Adam Bold, founder of The Mutual Fund Store

Overall, though, the mutual fund has the hallmarks of a value portfolio. The average forward P/E ratio as of Aug. 16 was slightly lower than the broad market. The companies have relatively low debt/capital ratios and plenty of cash to pay off any burdens (as measured by interest coverage ratios). The portfolio's average dividend yield is 2.2%.

Patience Is (Sometimes) a Virtue

Conviction in their stock picks has both helped the Crofts and, at times, hindered their performance.

Historical returns are telling: When the market bottoms, Croft Value tends to hit even harder because the managers stand by their picks—turnover is just 11%. During the late 1990s, the global currency crisis dinged Croft Value's natural-resources stocks, leading to a 25% loss in the third quarter of 1998. During this past decade, the fund dropped by 26% in the 2002 bear market, 4 percentage points behind the broad market, and in 2008 it suffered an 18% loss in the third quarter and a 25% loss in the fourth quarter, far worse than the S&P 500's declines. Each time, though, the fund has come back. The fund was in the middle of the pack in the wake of the tech bust, then landed in the top decile of its peer group for three straight years starting in 2005. Last year, it gained 38%, 10 points ahead of the category average.

"This is a deep-value fund. People have to be patient," Bold says. "There are going to be months or quarters when it takes the market longer to see the value the [managers at Croft] did."

One stock that encapsulates that thinking is Petrobank, the Canadian oil and natural gas

exploration and production firm. Petrobank has gone through a remarkable transformation the past decade thanks to both organic growth and acquisitions. Revenue and net income jumped to \$1.1 billion and \$145 million, respectively, in 2009, up from just \$46 million and profits of \$10 million in 2000.

The Crofts originally bought 13,000 shares of Petrobank for the Value fund in the second quarter of 2005 for about \$4.50 apiece. A cheap price tag wasn't the only reason the managers liked the stock. They also liked the macro themes of worldwide oil demand and Canada being second only to Saudi Arabia in terms of reserves. The company had sizable holdings in that country's oil sands and in fields in Colombia and Peru. Petrobank also had a proprietary, potentially environmentally friendly drilling technique that reduced the viscosity of trapped oil, making it easier to pump out of the ground.

The Crofts think Petrobank's Canadian and South American production subsidiaries alone support the \$38 price tag as of Sept. 3. That doesn't include the oil-sands reserves or the technology. Croft Value now owns almost 250,000 shares.

One big bet that hasn't worked out yet is Weyerhaeuser WY. Management has streamlined this one-time paper and pulp giant, shedding assets and using the proceeds to pay down debt. What is left is about 6 million acres of timberland and a company whose fortunes are tied to the housing market. The Crofts started buying the stock in 2006, when the shares were around \$60. Then, the downturn hit. The stock dipped below \$20 in early 2009. The Crofts, however, have stuck with it—even

adding more than 300,000 shares recently and inserting the bonds in Croft Income. They think the firm's recent conversion into a REIT will jump-start the shares like it did for similar competitors, and they are willing to wait out a rebound in housing.

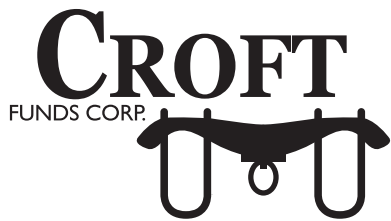
Can They Keep It Going?

For the year to date, Croft Value is down 0.2% through Sept. 3, a shabby showing on an absolute basis, but more than a percentage point ahead of the competition. The portfolio looks cheap, with an average forward P/E of 13 versus 15 for the S&P 500, while the estimated long-term earnings growth rate is 12%, 2 percentage points more than the broad market. That said, if Croft Value wants to stay in the top quartile of its peer group it will be on the back of industrial-material firms like Weyerhaeuser. The fund's weighting in that sector is 3 times that of the benchmark index.

The team at Croft will have some other obstacles with which to contend. As Croft Value's profile has risen the past few years, so, too, have fund flows. Assets have jumped to \$310 million from \$12 million four years ago. The firm has lowered expenses to 1.32%, down from around 1.5% a year ago. That is still a bit high, especially considering the huge inflows. (There is no formal schedule to reduce fees if assets hit certain levels.) In addition, the Croft sons will have the chore of passing along the wisdom doled out by their father as they take on more day-to-day responsibilities.

At least they won't have to worry about the building they call home. ■■

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