High-Flying Fund More Than Doubles in 'Lost Decade' for Stocks

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BOSTON (TheStreet) -- Patrick Gundlach's **Marshall Small-Cap Growth Fund**(MRSCX) has more than doubled investors' money in the so-called lost decade of the past 10 years.

And now the mutual fund manager is seeing a divergence in share prices from companies' prospects, leading him to conclude that investors are overreacting in driving stocks into a bear market. By following the fundamentals -- corporate profits have come in above research analysts' projections -- Gundlach says some stocks are getting more attractive the more they decline.

"We haven't made substantial changes [to the fund] recently because, like a year ago, we aren't seeing evidence of fundamental deterioration of our companies," he says. "We'll stick to our guns and believe we'll be rewarded for that, as we were a year ago, when we were much more likely to be adding to existing positions. While the stocks were acting negatively, we weren't seeing big fundamental changes. There was no evidence of anything substantially negative."

Small-cap stocks, as measured by the **Russell 2000** index, have plunged 22% in the past two months. Larger companies, which are perceived to be safer, have fallen a lot less -- the benchmark **S&P 500** is down 15%.

During this downturn, the steepest in three years, fund managers have been highlighting the defensive nature of large-cap stocks, with the most notable feature being the outsized, dependable dividends. Gundlach understands why investors would shy away from small-cap stocks these days, though that could become a costly mistake.

"You need a strong stomach for the moves that individual stocks have. The moves many of these stocks have can be pretty substantial," Gundlach says. "That can be nerve-racking for investors of any type to handle. But when you diversify, you can smooth out the volatility and company-specific risk. We'd say the current environment is providing a lot more attractive opportunities as opposed to reasons to be fearful."

For his part, Gundlach looks past headlines moving the market, from the constant barrage of uncertainty and negativity from the Eurozone to slowing economies across the world to ineptitude from the U.S. Congress. Gundlach employs a so-called bottom-up analysis of companies -- focusing on the basics such as orders and sales -- allowing him to take advantage of opportunities as they that present themselves.

Gundlach, who's managed the Marshall fund since mid-2007, looks for companies whose growth is explainable and sustainable. Based on calendar-year returns, the $617 million fund has outperformed the benchmark Russell 2000 Growth index in nine of the previous 10 years, with the only exception coming during the market meltdown in 2008. The Marshall Small Cap Growth Fund has a 10-year average annualized return of 7.8% as of June 30, compared to 4.6% for the benchmark index. An investor who put $10,000 into the fund a decade ago now has more than $23,000.

That outperformance and the discipline of avoiding speculation has helped Gundlach and his team navigate through wild swings in the market and decipher whether there are head fakes or sustained changes in the market cycle. That has been key for Gundlach as a small-cap growth fund manager, as that asset class typically outperforms coming out of a recession and usually gets crushed first going into a recession.

Gundlach isn't whistling through the graveyard, though. He's diligent about monitoring his holdings and potential investments for signs of weakness in fundamentals. Although he says it's too early to tell if this market decline is another head fake or economic cycle shift, he says he has seen a divergence lately that makes him positive on equities.

"Stocks are acting poorly even as companies put out fairly strong outlooks," Gundlach says. "In mid-August, we were going through earnings reports and more were beating than missing. That flies in the face of what you're seeing in stock action. And yet, small-cap stocks have been underperforming most of the other categories in this recent downturn."

Looking back over the period from March 2009 to now, Gundlach says the market and economy have been in recovery mode and that he's seen a few periods of uncertainty similar to the one investors are currently faced with. With the success he has had over that time, Gundlach offers three small-cap growth stocks that he sees opportunity in now that have been beaten down during the selloff.

Gulfport Energy(GPOR)

Company Profile: Gulfport Energy is an independent oil and natural gas exploration and production company. Gulfport's principal producing properties are located along the Louisiana Gulf Coast and in the Permian Basin in West Texas, and the company also has acreage positions in the Niobrara Formation of Western Colorado and the Utica Shale of Eastern Ohio.

Share Price: $22.37 (Sept. 26)

Performance Since July 25: -37.4%

Gundlach's View: In keeping with the fund's investment strategy, Gundlach likes Gulfport because the company has shown improving growth rates in both production of oil and gas as well as reserves, and the company should be able to maintain this growth in his view.

"In the energy space, we found often that it's a better indicator of a company adding value," he says. "The company shown very strong increases in the production growth rates." In the second quarter, for example, Gulfport said produced oil and natural gas sales volumes saw a 21% year-over-year increase.

Gundlach finds the company so attractive because of the acreage it has acquired in the Utica shale in Ohio, which has been a very hot area in the oil and gas industry. Gundlach notes that **Hess**(HES) recently acquired another company with acreage in the Utica shale, paying nearly $9,000 per acre.

"We estimate that Gulfport has close to 65,000 acres in the Utica shale," Gundlach says. "Doing quick math using that valuation in the marketplace, you get to a value approaching $600 million just for that Utica shale acreage. Gulfport has strong production and growth with a market cap of $1.4 billion, which we think barely recognizes the value of existing reserves and production."

Ebix(EBIX)

Company Profile: Ebix is a supplier of on-demand software and E-commerce services to the insurance industry. The company says it conducts in excess of $100 billion in insurance premiums on its platforms across the world in life, annuity, health and property and casualty insurance.

Share Price: $14.33 (Sept. 26)

Performance Since July 25: -26.2%

Gundlach's View: Gundlach forecasts big growth in the insurance software industry, as the group is very fragment and there has been a very powerful shift towards digitization.

"The insurance industry is one of the last big areas that has had most operations paper-based," he says. "Now, they're finally seeing the big shift towards digitization. Ebix allows for a cloud-based software as a service platform to handle all of these operations. Their software handles a lot of the operations in the insurance industry, from creating policies to maintenance."

Gundlach calls Ebix's growth in revenue and earnings "explosive." In 2002, the software company earned only 2 cents a share for the year. Analysts are currently expecting full-year earnings of $1.66 a share this year, according to a poll of analysts by Thomson Reuters.

"This is a company that has been growing by double-digits year in and year out, both organically and with some pretty smart acquisitions," Gundlach says. "Even though Ebix has grown incredibly fast for several years, there is quite a bit of running room left ahead." Analysts agree with that assessment, as the average analyst price target of $24.33 represents upside of nearly 70%.

Safeguard Scientifics(SFE)

Company Profile: Safeguard Scientifics provides growth capital for entrepreneurial and innovative life sciences and technology companies.

Share Price: $13.28 (Sept. 26)

Performance Since July 25: -27.5%

Gundlach's View: Gundlach views Safeguard Scientifics not as a bank but as a cross between a venture-capital firm and a private-equity shop. What attracted Gundlach, though, was the increasing rate of revenue growth.

Revenue growth of their partner companies is up substantially," he says. "In 2007, their partner companies had $100 million in aggregate revenue, which grew to $400 million in 2010."

Safeguard Scientifics currently has minority stakes of 20% to 40% in 13 companies, such as pharmaceutical company **NuPathe**, Internet career site **Beyond.com** and digital media trading technology provider **MediaMath**. Safeguard represents a solid investment for Gundlach and his team because these 13 business have been performing very well.

"Right now, the stock price of Safeguard is barely trading higher than the net cash on their balance sheet," Gundlach points out. "Effectively, you're getting their ownership stakes in 13 different companies for free, a variety of which are pretty exciting investment opportunities."

>>To see these stocks in action, visit the 3 Beaten-Down Small-Cap Growth Stocks portfolio on Stockpickr.

-- *Written by Robert Holmes in Boston*.

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