Small Cap Secret Sauce

When Scott Brayman asserts that his fund's worst days are still better than most people's best days, it doesn't sound too hollow next to the fund's top-quintile performance in the past 5-year and 10-year periods. Looking for small to mid-sized companies with some "secret sauce" is no revolutionary concept, but Brayman's execution on it deserves credit.

Q: Morningstar rates your fund with a "5 Star" overall rating and an "Above Average" return rating. Since the bear market set foot on Wall Street in 2000's first quarter, your fund has continually outperformed its category. What's your secret?

A: It is one word: Discipline.

Q: What stock index do you compare your fund with?

A: There are lots of ways to think about that. In terms of a stock index, as people traditionally think of stock indices like the Dow Jones or the Nasdaq, we think the best benchmark for us to compare ourselves to is the S&P 600 and it's also the one we use as the starting point for our process. In terms of measuring our performance, we think a group of established small cap managers without any heavy style bias would also make a good benchmark. We want to know how we are doing relative to other experienced small company managers who lack a heavy style bias. So scratch out the deep value investors and scratch out the folks with the heavy growth style bias and the 67% of those established small cap managers in the middle there, that's the group we compare ourselves against.

Q: What is your investment philosophy?

A: It's hard to separate our philosophy from our goals in my mind. But our goal, our purpose, is to make money and to manage risk. We want to create wealth for our shareholders and clients, but we also want to manage the risk. That is the foundation or the underlying premise. What we believe is that the Forbes 400 represents compelling evidence that a superior business model and a superior company can create immense wealth and it can also go a long way to manage something I call business risk. And if we buy those companies at a discount to fair value, we manage something called valuation risk. Another way to phrase it would be - quality companies at a reasonable price.

Q: Each day over 6,800 different stocks trade on the NYSE, AMEX and Nasdaq. How do you filter out the stocks to meet your standards?

A: When we're building our portfolio we try to develop a winning strategy for each of the key sectors. For example, let's take technology as a key sector. We want to build a strategy for technology that allows our technology sector to outperform the S&P 600 technology sector.

Sentinel Small Company A

Fund Facts		
Symbol	SAGWX	
Website	www.sentinelfunds.com	
Address	Sentinel Group, 1 National Life Drive, Montpelier, VT 05604	
Tel. No.	800-282-3863	
Inception	03/01/93	
Portfolio		
Total Net Assets *		$464.20
Avg Mkt Cap ($ Weighted) *		$1,100
Average Price/Earnings Ratio		23.87
Average Price/Book Ratio		2.53
Turnover Ratio		54%
Investment Information		
New Investment		Open
Min Initial Investment		$1,000
Min Subsequent Investment		$50
Min Initial IRA Investment		$1,000
Risk (Against S&P 500 - 3 Years)		
Alpha		1.4063
Beta		0.8784
R-Squared		0.7377
Returns vs. Lipper Small-Cap Core Index		
	SAGWX	Index
1 Year (Cum.)	2.62%	-2.37%
3 Year (Ann.)	6.53%	1.10%
5 Year (Ann.)	11.00%	2.98%
Returns vs. S&P 500		
	SAGWX	Index
1 Year (Cum.)	2.62%	0.25%
3 Year (Ann.)	6.53%	-11.20%
5 Year (Ann.)	11.00%	-1.61%
Fees and Expenses		
Max Sales Charge - Front		5.00%
Max Sales Charge - Deferred		0.00%
Max Redemption Fee		0.00%
Total Expense Ratio		1.22%
Portfolio Manager		
Scott Brayman		01/02/96

** millions* *Data through: 06/30/03*

Source: Company Documents; Lipper

Q&A TICKER's Choice

We have a sector weight rule that says that we are going to own no less than 75% of the S&P 600 key sector weight and no more than 125%, in other words we're never going to be more plus or minus 25% of the S&P 600's key sectors. We know we have to own something in each one of those key sectors, now we've got to decide how do we start this winning sector strategy? We start by looking at something we call our sector factors. For each of these major sectors: consumer, technology, financial, industrial and healthcare, we have a sector factor for each one. These sector factors do two things: we think that they dramatically winnow the universe and they also reduce business risk and improve the odds of success.

The companies that survive these key sector factors then move on to the next phase of our process where we ask ourselves which of these companies have many of the attributes that make them a superior business. A few attributes that are the most important to us, but are not the only ones we consider, are a high return on capital, high quality earnings, which really means strong operating cash flow and good balance sheets. In other words, they are not getting the high returns because of a lot of leverage, but they're getting high returns because it's a great business.

After we go through these attributes, we then do a lot of valuation work. That's where we sharpen the pencil and spend most of our time.

Q: What's the average number of securities in your portfolio?

A: Right now, we have 86, but we restrict ourselves to a range of 75 to 100.

Q: What about any foreign stocks?

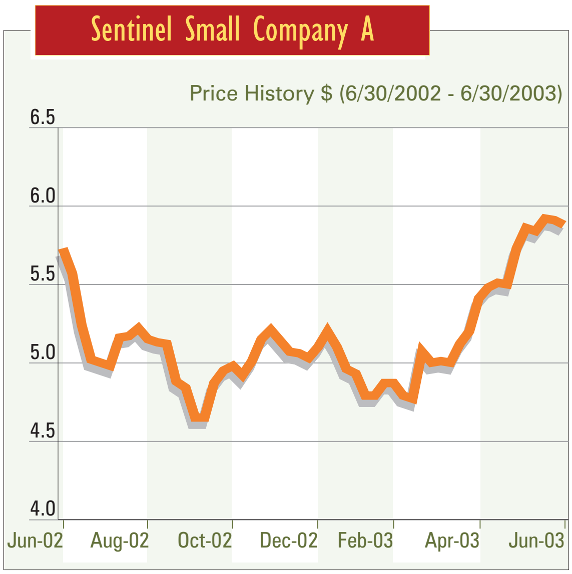
A: We've occasionally had one where it's been more of a technicality than an actual foreign company. We've never invested in a company whose primary markets are foreign. We are presently invested in a company, which is incorporated in the Virgin Islands, so technically it is a foreign company, but for all intents and purposes it's domestic.

Q: What's the average shelf life of your investments?

A: One to three years. That's our investment horizon.

Q: What's the market capitalization of the stocks you invest in?

A: We've been running around $1 billion weighted average market capitalization, but the sweet spot for us is really that $500 million to $1.5 billion range. Right now we're averaging around $1 billion and we've been hovering around there for a long time.



Q: Do you do your own research?

A: Yes, most of that is proprietary, but we do leverage the sell-side of the Street to help us understand the sector factor issues and even provide some insight into management. The attributes are pretty self-explanatory. In valuation, we again leverage the Street research for some modest help. We like to attend Street sponsored conferences too. At these conferences and through each stage of our process we also expose ourselves to other names outside the S&P 600. There is definitely a mosaic at work here, and all of us on the team have a lot of buy-side and sell-side contacts that contribute.

Q: How many are on your team?

A: There's myself, Chuck Schwartz and David O'Neal. Chuck mostly focuses on technology, auto, aerospace and defense sectors, while David, who joined us in January, focuses primarily on healthcare.

Q: What do you look for in evaluating companies?

A: What really makes a company standout for us is something that I call the "secret sauce." We want to own companies that have something special working for their shareholders. I am always asking Chuck and David, "What's their secret sauce?" Secret sauce can do one of two things, it can either reduce business risks, which is one of our goals - minimize risk - or it can improve the odds of making money, the other goal. For example, I think brands can be a secret sauce. They are often more valuable than patents.

Q: Do you use technical research?

A: No, but our traders are aware of this kind of stuff. It does not impact an investment recommendation or an investment action, but it can play a role in executing the trading strategy for a buy or sell recommendation. After we make an investment decision based on fundamental reasons related to our process, our traders will know about certain technical formations that may play a role and allow them to be opportunistic.

Q: I noticed that Morningstar has your portfolio broken into three basic industries: Information (11.1%), Service (58%), and Manufacturing (30.8%). Is this by design or by the market outlook of the sectors?

A: That's Morningstar. I don't view it that way. I think the high service component is because for the most part we like the kind of businesses that make high returns and tend not to be manufacturing companies. Instead, they tend to be service oriented; a business where somebody has a solution to a widespread problem and that solution doesn't require a lot of capital. We don't have a lot of information technology because that product-obsolescence sector factor is a pretty high hurdle to clear. We look very much like the S&P 600, there's no dramatic underweights or overweights on a sector basis. We think the small cap universe is inefficient enough so that we can add enough value over time through stock selection that we don't need to take a lot of sector risk or make big sector bets.

Q: Morningstar reported your turnover ratio was at 58%. Is that about right?

A: Yes, let me put a little bit of color in that because is doesn't necessarily reflect a complete transition in names. About 60% of our turnover is just trimming or adding to the same names. We've got a lot of key names, but we move the position size up or down based upon its valuation. In volatile markets like we have had last couple of years it has created a lot of opportunities. A lot of the volatility has taken place above and below fair value, so we are constantly selling and buying back. We are not constantly coming up with a whole lot of new names as 58% might imply.

Q: How fast can you act on an investment decision? As an example, I noticed on Friday, April 25, 2003, that Credit Suisse First Boston downgraded Viad, one of your largest holdings, to "Neutral" from "Outperform." On others, how would this impact your holdings?

A: We typically are not going to respond or act solely on the basis of a change in opinion by a sell-side analyst. What we will respond to is new information that we either develop through a mosaic from the marketplace or other sources, company reports, competitor press releases or when management delivers the news. When we get information that says, 'this business has a problem,' we take a hard look at that. There is one time you should definitely believe management; it is when they tell you they have a problem.

Q: How many stocks do you have on your "approved list?"

"Finding great businesses isn't as hard as buying them right and selling them right. I think the ***valuation is the hardest thing to tackle****. Often times when they are at their best price, emotionally it's extremely difficult to buy them. Conversely, when it is probably time to sell, you love them."*

About Scott T. Brayman:

Scott Brayman has more than 19 years of investment management experience. He joined Sentinel as an equity analyst in 1995 and was promoted to Assistant Vice President in 1996 before taking on his current responsibilities. Prior to joining Sentinel, he was a Portfolio Manager and Director of Marketing for Argyle Capital Management in Allentown, PA.

A: We do not have an approved list. We have a portfolio, which I would call the approved list and that's 86 names right now. Then we have a focus list of names that are warm to us and that's around 50.

Q: Is that by design or by the marketplace?

A: I keep the focus list and I limit it to 50. Focus and concentration are one of the keys to excellence. One could very easily argue that we should limit that list to maybe 10, so it has to stay under 50.

Q: It is like the old Boy Scout marching song, "Be Prepared."

A: That's the big part of our game! Absolutely. That's why all the work we are doing today could be money in the bank tomorrow even though it might not be in your price range today. The effort is going towards building a backlog and pipeline of potential ideas. That's when you go 'How quickly can you act?' Well, we can often act quickly because of prior work and keeping track of all that work electronically, allows us to be prepared.

Q: What's your outlook for the market for the balance of the year?

A: You know, we just don't know. On the one hand, valuations will tell us there's not a lot of upside left. On the other hand, we can see tremendous pressure on all the short interest out there that could propel a significant rally. I think a lot has to do with the economic news we get in the second half. I think we'll get a post-war bounce but because of a lot of the excesses from the bubble, I'm not sure it lasts. We just may need more time before we get into a sustained up move. So there's a lot of cross currents that cause us to say that we just don't know. But our discipline just tells us to stay focused on quality businesses and sell them when they're overpriced and reinvest in the ones that are most undervalued.

Q: Anything you would like to add?

A: We always like to try to leave with the message that everyone on this team feels incredibly fortunate, blessed even, to do this for a living. We think it's a privilege to manage other people's money. We realize our worst days are probably still better than most people's best days. ▮

John Fitzgibbon