Not a Typical Growth Fund

Manu Daftary, the manager of Quaker Strategic Growth Fund, has quite a different approach to investing than most growth managers. Instead of chasing the next huge growth winner, he focuses on avoiding the losers. He believes that managers should have as broad a mandate as possible to be able to pursue all opportunities, even if they are found in unusual places.

Q: ***What is the investment philosophy of Quaker Strategic Growth Fund?***

A: As the name suggests, we are growth investors. We believe that the markets are quite efficient and earnings momentum and earnings surprises are crucial for stock outperformance.

The growth universe is extremely volatile, especially on the downside. In order to outperform in a market where major losses easily occur, it is important to understand its structure. If you look at 10 growth stocks over a period of 20 years, 6 stocks will underperform the index, 3 will outperform in some random fashion, and only one is the Yahoo! or Google where, if you could, you'd want to have 100% of your portfolio invested.

I believe that finding the one super performing random stock is a matter of chance or luck. That is why our philosophy focuses on avoiding the six bad stocks. If we can do that, the four outperforming stocks should end up in the portfolio on a consistent basis.

The problem with most growth managers, in my opinion, is that they tend to focus on the one super outperformer. They believe that the losers are part of their process to get that one winner. Our philosophy is just the opposite - avoid the six, bring in the four and hopefully you'll get that one stock that really drives performance over time.

Q: ***How do you implement this philosophy into an investment strategy?***

A: We look at stocks on a GARP basis. We spend a lot of time making sure that our holdings are not prone to negative surprises. In that way, we try to avoid the inconsistency of returns over time.

This strategy requires diversification, adding positions gradually, and managing liquidity. Diversification is a must because no one knows where the next winners will come from. I find growth portfolios with only 20-30 names to be extremely risky because of the high downside volatility. If a stock goes down 40%, you have to be up 66.7% to break even and you will hardly be able to recover. That's why we, on average, own between 50 to 80 stocks in the portfolio.

Another important part of our strategy is to take smaller positions initially and add more if the company meets the milestones. These milestones are based on what the company has told us or on what we've researched. Liquidity is another important factor in avoiding downside volatility. To manage money

Quaker Strategic Growth

Fund Facts

Symbol	QUAGX (Class A Shares)
Website	www.quakerfunds.com
Address	Quaker Funds, Inc. c/o Citco Mutual Fund Distributors PO Box C1100 Southeastern, PA 19398-9951
Tel. No.	800-220-8888
Inception	11/25/1996

Portfolio

Total Net Assets *	$ 750.2
Avg Mkt Cap ($ Weighted) *	8,652
Average Price/Earnings Ratio	14.4
Average Price/Book Ratio	2.0
Annual Turnover Ratio**	205 %

Investment Information

New Investment	$ 2,000
Min Initial Investment	$ 2,000
Min Subsequent Investment	$ 100
Min Initial IRA Investment	$ 1,000

Risk (Against S&P 500 - 3 Years)

Alpha**	6.36
Beta**	0.67
R-Squared**	52 %
Ann Std Deviation**	10.20
Sharpe Ratio**	1.56

Returns vs. Benchmark: S&P 500 INDEX**

	QUAGX	Index
1 Year (Cum.)	23.92 %	12.25 %
3 Year (Ann.)	18.58 %	16.70 %
5 Year (Ann.)	4.80 %	-1.49 %
Fd Incep	19.37 %	7.28 %

Fees and Expenses

Max Sales Charge - Front	5.50 %
Max Sales Charge - Deferred	NA
Max Redemption Fee	NA
Total Expense Ratio	2.04 %

Portfolio Manager

Manu Daftary	Nov-1996
Chris Perras	Feb-2005

** millions ** for Class A without sales charges*

Data through: 09/30/2005

Source: Quaker Funds, Inc.

Important information on this manager and the Quaker Strategic Growth Fund appears on the last page.

in this universe, you cannot be limited to a single market-cap category. We have some market-cap minimum for liquidity reasons, but that is the only constraint. We want the entire universe, again because we don't know where the winners will come from.

In a nutshell, our strategy is to liquidity-weight the portfolio, tilt the portfolio to earnings surprise momentum, and avoid the losers. I believe it is better to tell clients that we have lots of little winners than the one big winner that most managers talk about.

Q: ***Can you describe your perspective for growth investing? Do you consider the historical growth as much as the forward-looking growth?***

A: We are looking at forward-looking growth. We are looking for reasonable valuations and high earnings growth. Right now, you can find such companies in the oil-drilling area, whereas the multiple of Google or Yahoo! is too high for us. Our companies have the characteristics of typical growth stocks, such as high return on equity, high cash flows, and even high price-to-book. When you compare our portfolio against the growth universe, we look very much like a growth manager, but we have very different stocks in the portfolio.

In the small and mid-cap area, valuation is not that important to us because these stocks tend to move on earnings momentum. We look for great franchise companies and alpha-generators that grow regardless of the state of the economy. In such cases, we are willing to pay a higher price-to-earnings multiple.

Q: ***Would you highlight your research process?***

A: We use traditional tools to identify investment opportunities. We do industry research; we travel to trade shows and investment conferences; we do one-on-one company meetings. Part of our philosophy is that we cannot invest in a small company without meeting the management. In the large cap segment, we don't feel that this is necessary because there is sufficient research in the public domain. I don't need to meet IBM's management to see what they are doing.

Also, we run quantitative earnings screens like the typical earnings momentum and earnings surprise models. Internally we use a very simple earnings revision/earnings surprise model for ideas. We do primary research for small-cap ideas and we use regional brokerage firms for maintenance research. Because our outlook is not out just one quarter, we don't need to visit the company every single quarter and can instead get updates either from the company or the regional analyst.

Once we decide that we have an attractive candidate, we do a thorough income statement and balance sheet analysis. Unlike other growth managers, we pay a lot of attention to the balance sheet because that's where the problems often start. We want companies that can be financed adequately in the capital markets, because they will need capital to sustain growth rates of 20%-30% a year.

We are always looking for balance sheets that can support growth over time and we don't like too much leverage. Also, if the company keeps issuing stocks, shareholder returns are diluted over time. Many growth managers think of top-line growth without realizing that they are getting diluted on the earnings side.

We avoid companies with large institutional ownership in the large-cap space, which is a contrary view to that of most investors. We always look for companies that institutional owners don't want to own for some reason. We feel that there is a margin of safety in those names.

Q: ***What are your benchmarks in terms of portfolio construction?***

A: We are a multi-cap manager, owning small, mid, and large-cap stocks, weighted on a liquidity basis. We broadly diversify the portfolio, holding 50 to 80 long positions. We have a 25% industry weight limit and we continuously monitor the portfolio on a daily basis. We can short up to 25% of the portfolio by mandate, however the average short position over the years has been about 7%.

We can also raise cash if needed. Back in mid 1999 and early 2000, we had invested more than 50% in cash in the portfolio to protect our shareholders. We like to be fully invested over time, but there are times when you need to take a certain type of action. In 1997, in a similar situation, we managed to avoid the effects of the Asian and the Russian crises. This also worked well during the market downdraft in 2000-2002.

Q: ***Do you have other means of risk control?***

A: We try to control the inherent volatility in the portfolio and manage downside risk. From December 1996 to September 2005, there were 62 up months in the S&P 500 Index and 44 down months. In the up months, the S&P 500 gained 3.85% on average and the fund gained 3.35%. On the downside, the fund lost 0.90% in the average down month, compared to 3.7% for the index. These figures illustrate the fact that the way to outperform is to manage the downside risk.

Q: ***Could you give us some examples of stock picks that have worked and that haven't worked in the past? What did you learn from the experience?***

A: We owned a company called Nextel Communications two years ago. It had a South American division, called NII Holdings, which was emerging from

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bankruptcy. This company was re-capitalized and was trading at about 8 times forward earnings. Any other growth manager would not look at it, but we noticed the company, talked to the management, and realized that the CFO of the parent company Nextel had taken over as president of this company. NII Holdings turned out to be my random stock, the one I never expected to do so well. Right now it is about 0.50% of the portfolio, but because growth has been so phenomenal, it is trading at 25 times earnings.

We usually have a problem when we don't listen to what the market is saying. For example, the management of a company expects great earnings and most people expect their revenues to be good too. But their revenues turn out light and, even if they meet their earnings, the stock begins to drop. At that point we blame ourselves for not paying enough attention to the revenues and earnings. Three years ago we had a similar situation with Tenet Healthcare and a year later with AIG.

With AIG, we weren't very comfortable with the management, but we still bought the stock, because it looked inexpensive. This is another mistake that we try to avoid. The quality of management is of primary importance, so we try to avoid buying stocks when we have doubts about the way a company is run, even if the company is good. We have had problems, but we try to minimize them and we sell the positions really quickly.

Q: ***How would you describe your sell discipline?***

A: We sell stocks if company fundamentals have changed and when stock price targets are met. If nothing else changes and earnings have gone up, the multiple is expanded, but if targets aren't met, we will sell it. We have stop-loss targets on the short side, which is very important. When shorting, losses can be unlimited, so we have a stop-loss of 15% - 20%.

We also believe that there is no harm in taking your profits and running away. I'd rather take the profits than a tax loss. We understand that the market is always right and it's bigger and smarter than any one manager or analyst. If a company meets expectations, but the stock reacts negatively, we sell the stock right away. The capital markets have already discounted these earnings and the stock is going to disappoint again in the next quarter.

> "In a nutshell, our strategy is to liquidity-weight the portfolio, tilt the portfolio to earnings surprise momentum, and avoid the losers. I believe it is better to tell clients that we have lots of little winners than the one big winner that most managers talk about."

about Manu Daftary

Manu Daftary is President and Chief Investment Officer of DG Capital Management, Inc. He began his investment management career at the University of Southern California in 1985 where he was Assistant Treasurer of Investments. In 1988, he joined Geewax, Terker & Company as a Portfolio Manager and was co-manager of the firm's institutional accounts. In addition, he also was Manager of equity short selling for the firm's hedge-fund assets and also designed the option overlay program that was utilized in the firm's institutional accounts. In 1993, he joined Hellman, Jordan Investment Management Company as a Senior Vice-President/Portfolio Manager. In 1996, he established DG Capital Management, Inc. Mr. Daftary has a MBA from California State University at Long Beach and is a Chartered Financial Analyst.

Q: ***What is the reasoning when shorting positions?***

A: We do fundamental shorts, looking very much for a reverse of what we look for when buying stocks long. We are looking three quarters ahead for companies that may miss earnings estimates. We don't do valuation shorts; I believe that's the worst short you can do. It's like shorting Google because you think it is overvalued. I don't want to buy it at this valuation, but I don't want to short it because the fundamentals are still very good.

We tend to short mid-caps stocks more then large-cap ones. If a large-cap company, like IBM, misses its numbers, it can go down 5% - 6% and then it tends to rally back up. The market is more forgiving with such companies. On the other hand, mid-cap stocks have a very high dispersion of earnings. They are usually only followed by 2 or 3 analysts and have a wide spread between expected earnings which gives them the earnings volatility we are looking for.

Q: ***What are some of peculiarities of growth investing that you have learned over the years?***

A: In my opinion, there are three things that a manager must do to outperform. The first one is being opportunistic and being able to go where the earnings are. A growth manager should be able to buy a steel company, even if steel is not considered a growth investment by conventional wisdom. Second, a manager must have a very broad mandate (but subject to risk parameters that the client is comfortable with). Third, size is very important. As a fund gets bigger and bigger, it's becomes more difficult to outperform. That's why our philosophy includes restricting the assets under management. ▮

TICKER Staff

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