Always Considering the Risk

One of the oldest mutual funds in the country, Sentinel Common Stock Fund, builds its track record since 1934 and its management is comfortable with the viability of the fund's strategy over full market cycles. The strategy looks simple - buying better than average companies and paying slightly below market prices – but the differentiation comes from identifying these companies and evaluating them considering the risk.

Q: *Would you describe your investment philosophy?*

A: Our philosophy is based on a long-term view and emphasizes diversification, high-quality bias, valuation discipline and below average risk. We think that a diversified portfolio of superior companies bought at attractive valuation levels, produces attractive risk adjusted long-term returns.

Our fund is a large-cap blend or core fund and we think it is a very compelling place to be. On the value side, there is large sector concentration in financial stocks, while growth funds depend more on the fortunes of the technology sector. We like the latitude that we have in the large core or blend area because we are able to move slightly in one direction or the other. For us, reasonably priced high-quality growth represents a very compelling risk-reward situation.

We are looking for the following qualities in the companies we buy: strong business franchise, credible and capable management, sustainable growth prospects, disciplined capital investment and strong free cash flow generation. We like companies that have discretion in terms of share re-purchase, dividend growth, or strategic acquisition.

Valuation is a crucial part of our investment process. There are many great companies, but if they are not purchased attractively, the risk-adjusted returns may be disappointing. The philosophy of strict valuation discipline and quality bias tends to help the portfolio perform better in down markets.

Q: *Do you place your emphasis on consistent earnings, above-average earnings growth, or tax-efficiency, for example?*

A: We have a long-term time frame and are looking at names that we can own for several years. Turnover is in the range of 35% to 50%. Our strategy is buying companies that have positive multi-year outlook, rather than buying on their first strong quarter or in front of a specific news event. We accumulate positions when things tend to be quiet and hopefully in front of a catalyst.

We look at valuation on any number of metrics – company relative to its history, its peers, and the market over time. We evaluate the upside potential, but with an emphasis on the downside risk and also using the dividend dis-

Sentinel Common Stock

Fund Facts

Symbol	SENCX
Website	www.sentinelfunds.com
Address	Sentinel Advisors Company National Life Drive Montpellier, VT 05604
Tel. No.	800-282-3863
Inception	01/12/1934

Portfolio

Total Net Assets *	$ 1,000
Avg Mkt Cap ($ Weighted) *	$ 84,300
Average Price/Earnings Ratio	22.07
Average Price/Book Ratio	4.35
Turnover Ratio	57 %

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	0.09
Beta	0.92
R-Squared	0.85
Ann Std Deviation	11.03
Sharpe Ratio	1.29

Returns vs. Lipper Large-Cap Core Index

	SENCX	Index
1 Year (Cum.)	11.45 %	11.47 %
3 Year (Ann.)	16.54 %	13.99 %
5 Year (Ann.)	2.72 %	-2.75 %

Returns vs. S&P 500

	SENCX	Index
1 Year (Cum.)	11.45 %	12.25 %
3 Year (Ann.)	16.54 %	16.72 %
5 Year (Ann.)	2.72 %	-1.49 %

Fees and Expenses

Max Sales Charge - Front	5.00 %
Max Sales Charge - Deferred	0.00 %
Max Redemption Fee	0.00 %
Total Expense Ratio	1.05 %

Portfolio Manager

Daniel J. Manion	09/17/1994

* *millions*

Data through: 09/30/05

Source: Company Documents; Lipper

Q&A TICKER's Choice

count model. We have to be confident that the valuation is sufficiently attractive and in the worst case, the downside is limited.

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

A: Our investment process starts with a very broad screening methodology of companies with market capitalization of over $2 billion and adequate liquidity. Some of the important metrics are higher than average ROE and free cash flow yield that is above market levels.

Thematic overlays are also an important part of our process. The large cap universe is quite efficient and you need some latitude in terms of sector weights to differentiate yourself. We are not sector rotators, but there are clearly some strategic themes that we play to our benefit.

For example, the positive stance on energy over the past 5 years and the ramifications of the rapid growth in China led us to basic materials stocks in 2003. We currently are invested in commercial aerospace and international infrastructure. The fundamental analysis gives us a number of potential candidates. We then develop some themes and biases that might lead us to overweight certain sectors and underweight others.

Q: ***What are some of the peculiarities of investing in large cap stocks?***

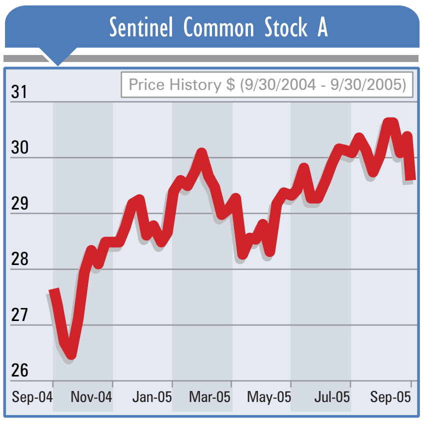
A: The multinational aspect is very important, because the companies we invest in are global in nature. From time to time we may own several ADRs, when they have better value or a compelling story, but they have to be liquid.

Although we have been consistent in running predominantly a large-cap portfolio, we have some flexibility regarding the market cap size. Currently, the fund has a weighted medium market cap of above $40 billion. Large-cap stocks are about 85% of the fund, while stocks with market cap of $2 to $10 billion represent 15%.

Usually, we go down the market-cap spectrum when we see distinctly better values or unique situations that are not available in the larger-cap universe, like in the period 2000 to 2004. At various points of time, our average market cap has gone down to $20 billion.

However, this phenomenon has largely been discounted and predominantly large-caps portfolios have an excellent risk-reward profile. In many cases, the large cap names in the same industry trade at discount to some of the mid-cap names, despite having more diversified and better business models.

Q: ***What is your formal process of research? How do you start, top-down or bottom-up?***



A: It is mostly a bottom-up approach. First, we look at some basic screens to work down the investable universe. We consider the discipline, how the management spends money over time, whether they generate free cash flow, what the returns on these businesses are. We look for better business models with brand names, installed user bases, recurring revenues. We focus on companies that have strong shareholder returns and are consistently profitable over time.

However, when circumstances dictate, there is plenty of room for economically sensitive or cyclical companies in the portfolio, like basic materials and energy. If the returns are not consistently high, we look at situations where we expect a substantial improvement.

Q: ***Would you describe your portfolio construction process?***

A: We have some exposure to all the major S&P sectors like basic materials, industrials, telecom, consumer discretionary, healthcare, energy, financials, staples, technology, and utility. Our weightings for some of the major sectors are plus or minus 50% of the benchmark. Energy, for instance, has been slightly higher, given the market appreciation. For smaller sectors, we have more latitude.

We don't run a concentrated portfolio. The top ten stocks represent about 22% of the portfolio. We typically hold from 75 to 100 names in a portfolio; currently it is closer to 95. We may hold 5% of a company at cost, but it usually doesn't reach those levels. The average position is 1%, while 2.5% to 3% would be considered large positions. We stay fully invested with cash of about 2%.

Q: ***What is your buy and sell discipline?***

A: To buy a stock, we have to be aware of both the potential risks and the upside and be very comfortable with the valuation and entry point. We also compare potential new purchases to existing holdings. It is a two-step process: a new buy recommendation usually comes with a suggested source of funds. If it's not compelling versus what we already own, we are less likely to act aggressively on the buy side.

In terms of the sell discipline, price targets are not rigid. If fundamentals continually improve, price targets may be subject to revision. We sell when the fundamental situation is deteriorating or when the original investment thesis is no longer valid. We consider ourselves patient and low-turnover investors, but we are unlikely to embrace controversial situations. Very large individual positions or sectors are trimmed occasionally on strength or just from an overall risk-management/ sector concentration viewpoint.

Selling occurs either on price target, or when fundamentals deteriorate, or when an investment works out unusually well and we think it is prudent to take some money off the table. That was the case for energy over the past 6 months.

Q: ***What are the major risks you face and how do you manage them?***

A: The high-quality bias and not being involved in speculative stocks or stocks with unusually lofty expectations, helps to reduce risk. Being well grounded in valuation and sticking to consistently profitable companies is a risk control. The portfolio holdings have higher ROE and higher projected rates of earnings growth versus the index, but trade at discounts to the market on a P/E and on EV/ EBITDA basis. We think that we are buying better than average companies and paying slightly below market prices.

The dividend yield is roughly in line with the S&P, but dividend growth rates are higher than the market's because of the emphasis on consistent cash flow generators. We own a number of companies that have announced double-digit dividend hikes lately and are simultaneously buying back shares outstanding. When you look at market periods of modest equity returns, such as the last 5 years, dividend yield starts to matter. With the change in dividend taxation, it will probably continue to attract investor attention.

Q: ***How does valuation help you find the right company? Can you give us some examples of recent successes that helped build your alpha?***

A: In 2000, it became increasingly apparent that natural gas supplies in North America were going to grow less rapidly and at the same time the demand was increasing because of increased electric power generation and environmental issues. We looked at natural gas exploration and production companies. Making very modest commodity assumptions, we looked at the cash flow multiples and thought that this was a very intriguing risk-reward situation.

One of the names that we bought was EOG Resources, a company with sufficient liquidity, a disciplined strategy, conservative capitalization, and a market cap that made sense for us. A number of other companies were burned by tremendous amounts of debt, which was not the case with EOG. We liked the diverse asset base and their production growth prospects. That stock has worked well for us; it has been less volatile than people would expect from an energy commodity stock.

Within sectors, we look for the better-valued names. For instance, in the diversified industrial sector, GE has been in the fund for a long time, but United Technologies looked increasingly attractive in our work. UTX has exited the more cyclical low-return type of businesses like auto parts, and re-deployed capital in Carrier, a heating ventilation and air-conditioning firm, and in Otis Elevator, which both have a high-margin service component. The differential in the multiple within one sector led us to a substantial commitment in United Technologies. It has been a very good stock for us for several years.

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about Daniel J. Manion, CFA

Dan manages the Sentinel Common Stock Fund, co-manages the Sentinel Balanced Fund and the Sentinel Capital Opportunity Fund, and is the director of equity research. Dan joined Sentinel in 1993, and was named Vice President in 1998. He has over 18 years of investment management experience.

A CFA, Dan received his undergraduate degree from the University of Oklahoma, and his M.B.A. from the University of Bridgeport. He is a member of the New York Society of Security Analysts, the Vermont CFA Society and the CFA Institute.

Q: ***How do you think your fund differs from the other large-cap core funds?***

A: The organization along product themes is a differentiating factor. Analysts are focused on their investable universe with research coming from different sources. People can spot trends and develop investment rationale based on several sectors. We look at themes first, bring them down to a specific story and then look at the merits of each investing theme from a valuation perspective.

We hire people who are generalists, and give them several sectors of responsibility. This creates an attractive career path and opportunities; they are given discretion to have substantial input in sector weightings and the direction of the portfolio.

The longevity and the size of the fund are another differentiating factor. This fund is Sentinel's oldest fund, its flagship product founded in 1934, and has $1.1 billion in assets. It is one of the oldest mutual funds in the country. Even though in any individual year we are not taking bets that may lead to top decile performance, consistently good performance and risk-adjusted returns add up to a strong long-term track record. ■

TICKER Staff