Opting for Realized Gains

Using equities in a debt-like fashion is a rare approach, but Kelmoore Strategy® Eagle Fund convincingly executes it. The fund aims to achieve yields similar to that of junk bonds, but with the comfort of holding an A-rated equity portfolio. Using covered option writing, the fund's strategy relies on the safety net of large-cap bellwether names and on the manager's ability to pick the right entry points.

Q: ***What is the philosophy of Kelmoore Strategy® Eagle Fund?***

A: The Fund's goal is to maximize realized gains from covered option writing; it's exclusively what we do. Our portfolio consists of leading equities mainly from the technology, financial, and biotechnology sectors. We invest in financially strong, profitable companies.

We look for stocks with higher levels of implied volatility than the market average. Implied volatility is the market's prediction for future movement in an equity. Expressed in percentage terms, it translates directly into option premium levels. For example, if an option trades at a "40 vol", it means the market is anticipating the underlying equity to have a 40% move over the next 12 months, either upside or downside. That's a big move and it translates directly into option premiums.

Ideally we seek names with implied volatility of at least 24. We currently hold a portfolio of software, hardware, semiconductors, financial companies, biotechs, and a special category for names with higher implied volatility that don't fit in the other categories. For example, McDonald's may fit this category because the options trade near their high implied volatility right now.

Our strategy is to buy the stock, write calls against it, and distribute the realized gains to investors on a monthly basis. Although total return is important, we market this fund as a cash flow alternative. Our 12-month yield is 12.6%. We try to have an A-rated equity portfolio with a junk-bond type of yield. We use equities instead of debt instruments to create this type of yield.

Today the fund owns about 25 stocks and has $250 million in assets. Strong fundamentals are important in stock picking, but we also want to take good entry points. We look for upside when picking a stock that competitors reject, or a stock we hope can go higher. We may actually do well owning stocks with high levels of implied volatility that do nothing. We pay distributions to our investors and I write another set of calls for the next month(s).

Q: ***So you have a short-term exposure of about a month?***

A: A month on the option side. We are almost exclusively selling near expiration options because you get the greatest yields.

Kelmoore Strategy Eagle

Fund Facts

Symbol	KSEAX
Website	www.kelmoore.com
Address	Kelmoore Investment Company, Inc. 2471 East Bayshore Road, Ste. 501 Palo Alto, CA 94303
Tel. No.	877-535-6667
Inception	6/29/2000

Portfolio

Total Net Assets *	$ 144.4
Avg Mkt Cap ($ Weighted) *	$ 70,000
Average Price/Earnings Ratio	25.94
Average Price/Book Ratio	4.34
Turnover Ratio	153 %

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	-0.45
Beta	1.39
R-Squared	0.81
Ann Std Deviation	15.55
Sharpe Ratio	0.69

Returns vs. Lipper Large-Cap Core Index

	KSEAX	Index
1 Year (Cum.)	3.39 %	8.67 %
3 Year (Ann.)	11.98 %	10.73 %
5 Year (Ann.)	-15.23 %	-2.75 %

Returns vs. S&P 500

	KSEAX	Index
1 Year (Cum.)	3.39 %	8.72 %
3 Year (Ann.)	11.98 %	12.85 %
5 Year (Ann.)	-15.23 %	-1.74 %

Fees and Expenses

Max Sales Charge - Front	5.50 %
Max Sales Charge - Deferred	0.00 %
Max Redemption Fee	0.00 %
Total Expense Ratio	1.84 %

Portfolio Manager

Matthew Kelmon	6/29/2000

* *millions*

Data through: 10/31/05

Source: Company Documents; Lipper

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Q: ***What is the best case scenario for your approach? Is it if the underlying stock doesn't do anything because then you collect the entire premium yourself?***

A: In this environment option premiums are about as low as they've been in 10 years. We are just now moving up from a 10-year low for implied volatility. There are pluses and minuses to that environment. In higher-volatility environments you earn more for options and we tend to sell options at 3% to 5% even 7% out-of-the-money each month, which means the underlying equity could move up by that amount.

The ultimate scenario for our portfolio is actually a very mild rise in the markets. With a 1% rise per month in the equity market, we'd see a rise in the portfolio and we'd earn the money from the options expiring, but that's a best case scenario in terms of total performance. In terms of outperformance in a market that does nothing, when we are able to get option premiums of 12% a year, or 1% a month, then we might outperform by 12%.

Q: ***Why have you chosen this type of investment philosophy? What are the inherent benefits of writing covered calls and using the cash flow for distributions?***

A: We've had investors who invest only in short-term GE paper, for example, which pays very little but is not risky. What we do is own the stock and write a call against it. Owning the same company and using the equity we may be able to earn 0.75% a month, in the case of GE. We are also entitled to any dividend, so we'd get the dividend yield in addition to the option premiums.

It's a different philosophy. We use equities instead of debt instruments and that provides us with a risk/reward ratio that may be favorable for the investor. If you want to invest in the debt instrument, you are probably willing to invest in the equity with written options on it. Of course, entry points are crucial, but you may be rewarded with our investment style to a greater extent than in the debt market.

Q: ***You mentioned that you have about 25 names in the fund. How big is the universe that you draw from?***

A: I scan the Nasdaq 100 daily. The universe consists of probably no more than 150 stocks. The S&P 100 and the Nasdaq 100 are essentially where I look for candidates.

Q: ***Various sectors have various volatility and bond yields change as well. Do you consider macro themes and their implications on volatility?***

A: We believe in market cycles. There are similarities between what we are experiencing now and 1994, which is low volatility and relatively low interest rates expected to increase. Low rates bring speculation on smaller-cap companies because it is cheap to borrow money. As rates rise, we focus on large-cap companies with healthy balance sheets because the cost of borrowing rises and large caps tend to need to borrow money less. In this stage of the cycle, investors turn to large-caps, not because they offer greater appreciation potential, but for the safety factor. Small and mid-caps tend to do well at the beginning stages of a recovery, while at later stages, larger-caps tend to excel.

Finally large caps, even in the tech sector, are trading at all-time low multiples. Oracle and Intel are trading at a discount not to their sector, but to the market as a whole. Some of yesterday's big winners are now value plays. Valuation may represent a safety net although you are not rewarded as much on the implied volatility side. That is the trade off - there aren't tremendous option premiums, but these stocks provide some protection because of their low valuation and the expectations for future valuation.

Q: ***Do you see an opportunity in the fundamentally weak auto sector, where GM is being downgraded? Volatility could dramatically increase even though these are large-cap companies.***

A: Good point. We own GM in our Strategy Fund, not in the Eagle Fund. When I feel an opportunity and once we decide fundamentally that the company will exist and survive a downturn, or when the perception is too short-term and implied volatility picks up, if we don't have a position in the name and the stock trades down dramatically, we may sell puts below the current market price. That's the other facet of our strategy. I especially like to do that with beaten up stocks where the implied volatility has jumped up. We would never sell a put on the equity if we weren't willing to own it at that price. However, I am also willing to sit and if the stock doesn't trade down, take my 5% for the next two months. If we earn that and it expires worthless and the stock doesn't trade below that level at expiration, then we pay that premium to our investors.

Q: ***Since benefiting from volatility is not an easy job, what have you learned from your experience in deciphering volatility? There can be union risk, as in the case with GM, or market share risk, or a foreign market risk, or balance sheet risk, etc. Do you take into account all of these factors or do you stay focused on the numbers?***

A: We are driven by numbers, but we pay attention to fundamentals and news. Risky stocks may become opportunities; we sold Tyco and Haliburton puts when no one wanted to own them and it turned out well. When implied volatility jumps high, it's almost like

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looking at a stock with a very low P/E and a high dividend. While this may look like a great deal, it often means that they are either about to cut the dividend or to miss earnings. It can be scary sometimes when implied volatility jumps way up, so we mine the market for the highest implied volatility and for financially sound companies that are leaders in their respective industry. On any given day, there are names with higher implied volatility than the names we own, but they lack other characteristics necessary to be included in our portfolio.

Q: ***In terms of portfolio construction, do you have limits on the number of names in a specific sector to diversify?***

A: Right now I have a lot of technology, with about $70 million in software, $85 million in hardware, and $61 million in semiconductors, so I do balance the industries. I don't balance them exactly, but when I have turnover or new cash I am aware of not getting too much out of balance in any one area within technology, biotech, or finance.

Q: ***What is your approach to research?***

A: For the Eagle Fund we mine the top half of the S&P 100 and the Nasdaq 100. Research is mainly technical and is about picking entry points. Being in and out at the right time, that's what it's all about. I look for the right time on names we are interested in. If we want a particular name, let's say Intel, I might look for the mid-quarter update because implied volatility tends to get pumped up before an update or earnings report. If I am aggressive and want to own it, I will buy it. Otherwise, I will try to sell at-the-money or slightly out-of-the-money puts.

Then I am rewarded based on whether the stock moves up or not. If it moves up dramatically, I miss some opportunity, but in the last few years that's been rare. Names like Intel don't move $3 or $4 a day like they did in the 90s. Now people get excited if they move $0.40 a day, which makes my decision a little easier although I don't get the huge one-day returns. At times I will build a position, then the stock trades up and I might even write calls before a potential market move. As volatility comes off, time/value flows out of the option and I can profit without the stock doing anything.

> "If you want to invest in the debt instrument, you are probably willing to invest in the equity with written options on it. Of course, entry points are crucial, but you may be rewarded with our investment style to a greater extent than in the debt market."

about Matthew Kelmon

Matt Kelmon, President and Head Portfolio Manager at Kelmoore Investment Company, manages all three of Kelmoore's mutual funds: the Kelmoore Strategy® Fund, Kelmoore Strategy® Eagle Fund, and Kelmoore Strategy® Liberty Fund. Mr. Kelmon is a noted expert on options investment strategies and has appeared in the national media, including CNBC, The Wall Street Journal, Fortune, The New York Times, Barron's, CNN, and Bloomberg.

Since joining Kelmoore Investment Company in 1994 as the firm's Trader and head Portfolio Manager, Mr. Kelmon has been instrumental in the strategic direction of the firm's investment policies, portfolio management decisions, and trading systems.

Q: ***When choosing your entry points, do you also perform fundamental research on the stocks?***

A: For us the key is sticking to the highest-weighted names in the large indexes. We don't feel that we can get an edge on General Electric or Intel because everyone is following these mega-cap names. Mainly it's technically driven and volatility driven.

Q: ***So, when you invest in a narrow universe followed by many people, the level of surprise is minimal, unless, of course, you are dealing with outright fraud. Is that correct?***

A: For successful covered option writing, avoiding disasters helps; it's nearly impossible with a broadly diversified portfolio. This market does not offer the tremendous rewards of the 90s. In this static environment you are rewarded maybe 1% to 1.5% for each covered option. A nightmare is owning Merck at $50 and then waking up to find it costs $35, because you only have $1 for writing a call.

For example, I currently own Research in Motion at a lower level. Before the earnings report I waited for almost a month to close in-the-money calls and I used all the premiums to buy out-of-the-money puts. That saved me today because the stock is down $8.

Q: ***Even though a substantial part of your risk is covered by being in the S&P 100 and Nasdaq 100, what are the risk control measures that you have in place?***

A: Generally, even if the stock does not trade dramatically higher, we want to see positive cash flow, forward earnings growth and we stick very much to the industry leaders. Although unfortunately I didn't own Google on the IPO, we'd rather see a story develop, some earnings growth and positive cash flow before we become comfortable with a new company. ▮

TICKER Staff

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