Keeping It Simple but Efficient

Making money over the long term is what Al Frank's philosophy is all about. Achieving Buffet-like returns since 1977, Al Frank Asset Management relies on a simple, disciplined philosophy based on what has worked historically. Patience, diversification, and stock selection, in that order, are the cornerstones of investing the Al Frank way.

Q: ***What is your investment philosophy?***

A: Our philosophy is pretty simple. We invest in undervalued stocks, no matter their size, though the bargains have historically congregated in the small-cap area. We hold our stocks for their long-term appreciation potential in broadly diversified portfolios. The cornerstones are patience, diversification, and stock selection in that order. This philosophy stems from our investment newsletter The Prudent Speculator, which was launched in 1977 by the founder of our firm, Al Frank. He regularly invested his own money and his objective was to prove that you didn't need a Ph.D. in Finance to be successful. What you do need is an understanding of history and the discipline to consistently implement a value-based investment strategy.

Going back to the 1920s, we see that equities are the right place to be because they have historically returned between 10.4% and 12.7%, depending on capitalization. The next logical question is what type of equities. Value has significantly outperformed growth with value defined as companies trading at low price/book ratios, i.e. an inexpensive fundamental valuation. Also, smaller capitalization companies have outperformed large-cap stocks. It isn't rocket science, then, to conclude that if one invested in small-cap value stocks, he would be more likely to succeed.

We also know that the longer stocks are held, the less risky they become. Statistics shows that if you invested in the S&P 500 for one year, there is a 29% chance of losing money. If you hold for 5 years, the risk of loss declines to 13%; for 10 years it drops to about 3% and for 15 years to 0%. This refers to absolute returns, but another analysis (performed by Wharton's Jeremy Siegel) of 200-year inflation-adjusted return shows that there has never been a 20-year period in which you would have lost money, even on a real-return basis, investing in equities.

So the real key to our success is not necessarily stock picking, but stock holding. Yes, we want to buy undervalued stocks and we have years of experience honing our stock selection skills, but it is more about the willingness to stay with our stocks through thick and thin. Of course, the merits of long-term

Al Frank Fund

Fund Facts

Symbol	VALUX
Website	www.alfrankfunds.com
Address	Al Frank Asset Management, Inc. 32392 Coast Highway, Ste. 260 Laguna Beach, CA 92651
Tel. No.	888-263-6443
Inception	1/2/1998

Portfolio

Total Net Assets *	$ 257.3
Avg Mkt Cap ($ Weighted) *	$ 11,500
Median Mkt Cap *	$ 1,300
Average Price/Earnings Ratio	19.50
Average Price/Book Ratio	2.44
Turnover Ratio	25 %

Investment Information

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

Risk (Against Russell 2000 - 3 Years)

Alpha	0.37
Beta	1.11
R-Squared	0.94
Ann Std Deviation	18.06
Sharpe Ratio	1.35

Returns vs. Lipper Mid-Cap Value Index

	VALUX	Index
1 Year (Cum.)	11.06 %	11.39 %
3 Year (Ann.)	31.80 %	19.52 %
5 Year (Ann.)	17.06 %	12.12 %

Returns vs. Russell 2000

	VALUX	Index
1 Year (Cum.)	11.06 %	8.14 %
3 Year (Ann.)	31.80 %	20.01 %
5 Year (Ann.)	17.06 %	10.12 %

Fees and Expenses

Max Sales Charge - Front	0.00 %
Max Sales Charge - Deferred	0.00 %
Max Redemption Fee**	2.00 %
Total Expense Ratio	1.61 %

Portfolio Manager

John Buckingham	1/2/1998

** millions ** within 2 months after purchase*

Data through: 11/30/05

Source: Company Documents; Lipper

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holding also include lower transaction costs and higher after-tax returns. Not having to worry about emotional headlines and the daily ups and downs of the manic markets also makes it much easier to get a good night's sleep. We have a very low turnover, about 15% a year, for our recommendations in our newsletter as we hold our stocks on average for about six and a half years.

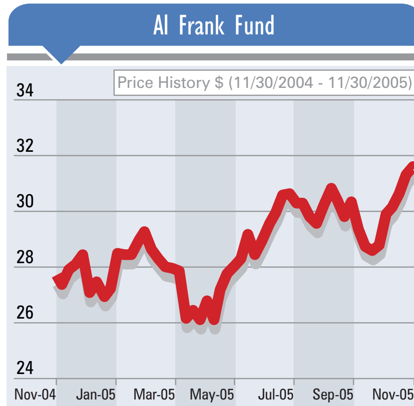
Of course, we've had periods when we've stumbled, just like everybody else. The year 2002 was awful for our mutual fund, we lost 26%, but in 2003 we were up 78% which more than compensated for the decline in 2002. What did we do differently? Nothing! The same stocks that went down 26% went up 78%. It is never a matter of changing our philosophy to chase what is hot. We didn't become Internet stock investors in 1999 but we did manage to make 60% in our mutual fund that year. The reason was that we had a lot of technology stocks, which were value-priced when we bought them primarily in 1998 during the Asian crisis. The point is that we had to sit with them and eventually we were rewarded over time.

We also believe in broad diversification because nobody has a crystal ball. The old saw is that you need 20 to 30 stocks to handle all the risk, but I believe that this is no longer the case. We have done some analysis and there are academic studies that are now suggesting that you need at least 120 stocks in a portfolio to control the risk. In the 1960s and 1970s brokerage commissions were significantly higher, but now it doesn't cost us anything extra to buy 5000 shares of something new as opposed to 5000 shares of something that we already own. Our flagship Al Frank Fund has 350 stocks and our new Al Frank Dividend Value Fund has about 175 stocks.

Despite our premise that small-cap stocks are usually where the value and the bargains are, we don't limit ourselves to any allocation box. If you do that, we believe that you are going to limit your returns. The perspective allows us to invest in whatever we think is undervalued, without any arbitrary restrictions.

Q: ***Do you look for a catalyst when selecting stocks?***

A: We buy in advance of the catalyst, while many investors wouldn't buy a stock without a catalyst on the horizon. We buy a company for its 3 to 5-year prospects and think that a catalyst will emerge at some point in the future. When the catalyst emerges, it often is too late to buy the stock and that's what many investors don't understand.



For example, we had a company called InVision Technology, a maker of explosive detection devices. We first bought it at about $3 because they had over $1 per share in cash on a debt-free balance sheet. The business seemed like it had some promise; they were selling their products to Israel because they were the only ones seemingly worried about terrorism at the time. After 9/11, Congress decided to put those devices in just about every airport and all of a sudden, the company moved from making 20 devices a year to making 20 of them every two weeks and the stock followed suit, eventually being bought out by General Electric for $50. Obviously, we didn't know that terrorists would attack the U.S. on that September day, but we did know when we bought InVision that we were picking up an undervalued stock.

Q: ***What are the main pillars of your research process? What is your way of seeking value?***

A: We focus on what we call the big three, which are earnings, sales, and book value. So we look at P/E ratio, price/sales and price/book value in relation to where the company has traded historically. We look at both trailing 12 months and forward 12 months earnings. In a nutshell, we are buying companies that are trading at the lower end of their historical ranges or that operate in sectors that may temporarily be out of favor.

For a cyclical company, we seek to normalize earnings because often these stocks should be bought when they are losing money and sold when they are making a lot of money. If you just consider the P/E, you might end up selling low and buying high. So the analysis depends on the sector or the company you are looking at. For many technology companies, the P/E may be overridden by other factors, such as a low price/sales ratio or having a lot of cash on the balance sheet. We often will cash-adjust our metrics, meaning that a $5 stock earning $0.20 is trading for a P/E ratio of 25, but if the balance sheet has $3 in cash and no debt, we are really only paying $2 for the business, or 10 times earnings.

Of course, we also favor traditional value companies trading at low price/earnings ratios. The homebuilders are a perfect example, although they should be in growth-stock portfolios as well because there is no industry growing faster and no industry that is cheaper in terms of share price.

Q: ***The housing sector has consistently been under-loved in my opinion. Do you think that is because of the historical experience or because of the reluctance to***

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understand how the housing market has changed?

A: Housing is one of our favorite sectors to talk about. Why is that? Take D.R. Horton, for example. This giant homebuilder has posted record sales and earnings for 28 straight years, through interest rate fluctuations, recessions and changing housing dynamics. When the bubble burst in California in 1989-1990, they still made money and grew earnings and sales. This is the ultimate growth stock; there aren't any other publicly traded companies that we know of that can boast 28 straight years of record numbers.

Of course, we know that the housing market is slowing and the media reminds us everyday that there is a housing bubble ready to burst. But D.R. Horton management has actually gone on record saying that they expect earnings to grow at an annualized pace of 15% to 20% over the next five years. And the forward P/E today is less than seven. Interestingly, that multiple is the same as it was six years ago when we were first buying D.R. Horton, but the stock price is up some 800% since then because the E part of the P/E has climbed by some 800%.

I am wholeheartedly in the camp that says that demographic trends, shortages of land, the difficulty of getting through the regulatory process, the better access to capital that the large builders enjoy and economies of scale all favor our housing stocks and these factors are not going away. People consider interest rates to be a risk, but rates were 4.7% on the 10-year Treasury when the Fed started tightening in the summer of 2004 and today they are 4.5%. There are pockets of the country that will go through ups and downs, but when you are geographically diversified, you are not as likely to be impacted by the problems in one market, and if you look at housing prices historically, there has never been a year when on a nationwide basis housing prices have gone down.

Q: ***Many of these companies have used the good days to clean up their balance sheets because they were heavily leveraged in the past.***

A: Indeed - bond ratings have certainly improved because the companies post consistent earnings year after year. And now, they are paying dividends as well and D.R. Horton, Centex and several others have announced big share repurchase authorizations.

Q: ***What is your approach to controlling risk?***

A: People make emotional decisions when it comes to investing, but you can control emotion by focusing on what has worked historically - diversifying, buying undervalued stocks and having the patience to stay with them. With our approach you also save on commissions and gains are usually taxed at the lower long-term rate.

We actively follow 1,100 companies. We have three other folks who are involved in the analysis, but we do not spend our time meeting with management nor would I say that we know our companies intimately. Simply put, if you buy companies with inexpensive valuation metrics, you are essentially choosing from a universe of stocks that are destined to outperform. Of course, you will have failures, which is why you have to diversify, but the odds are in your favor.

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

A: We only part with a stock when it has eclipsed its Goal Prices, our determination of long-term, three-to-five year fair value. We like to say that our favorite holding period is forever, but we have sold stocks in short order if they suddenly get hot or if the conditions that justified our purchase suddenly change in a dramatic fashion. Generally speaking, we do give our stocks all the time they need to fulfill their potential and happily our winners have won far more than our losers have lost. ▮

TICKER Staff

> "The amazing thing about a long-term investment orientation is simply common sense – it is less risky and more profitable."

about John Buckingham

John Buckingham is President, Chief Portfolio Manager and Director of Research for Al Frank Asset Management (AFAMI) as well as Editor of The Prudent Speculator and The Prudent Speculator Tech Value newsletters. Buckingham actively follows more than 1,100 stocks for money-management clients and newsletter subscribers and is Manager of The Al Frank Fund and the Al Frank Dividend Value fund, both are no-load equity mutual funds. He has been associated with AFAMI since 1987.

Mr. Buckingham graduated magna cum laude with a B.S. degree in computer science and a minor in business administration from the University of Southern California in 1987. He has been an interview subject of numerous publications, radio and television programs and also conducts workshops at investment seminars. He lives with his wife and daughter in Laguna Niguel, California.

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