

The Power of Compounding

Instead of chasing hot stocks and sectors, Auxier Focus fund aims at compounding stable returns year after year. Avoiding the sharp downturns is a key issue as protection is high on the priority list of the manager, Jeffrey Auxier. He believes that his job is to minimize risk and to find the businesses that are here to stay in the long run.

Q: Could you describe your investment philosophy?

A: The key concept in our philosophy is the power of compounding. We have huge respect for compounding because it leads to strong aversion to permanent loss of capital. We're always looking down first to see how much we can lose before we look up. It is extremely important how well a fund does during downturns, because it may be up 50% in the first year and up 50% in the second year, but if it's down 50% in the third, it will do worse than a constant 8% all the way through that period.

What we try to do is beat the market on a rolling 12 month period and achieve consistency and performance because investors need a systematic low risk approach that protects them in the downturns.

One of our goals is teaching the clients that by protecting them in flat to down markets and matching the ups, they'll outperform over the long run. Everyone likes to concentrate on their five best ideas and hit home runs, but I believe that you have to protect first and then keep compounding. People don't understand well enough the importance of compounding and that investing is about discipline, hard work, and thrift. There's nothing glamorous about it.

Q: What's your strategy for achieving these goals?

A: I believe that we're not paid to take risks, but to minimize them. We are paid to be thrifty, to find superior business models, to monitor and understand them. Our first job is to assess the investment in its entirety. If it's a company, we do a complete analysis of the balance sheet, the revenues, and the margins. Then we determine what is the risk of being wrong, because we try to avoid 'torpedoes', or high-expectation, high-operation companies that can get hurt on the downside.

We constantly compare businesses against stocks to evaluate how strong the franchise is. We're watching the stock and we're trying to determine why it is down or up. Is it because of floods of easy money, IPOs in the industry, or are people making irrational global investments? For example, it could be just the excitement over new technology leading to irrational behavior. We determine whether it is a permanent or a temporary situation. If it's temporary, we're interested.

Ideally, we'd grow the portfolio by buying cheap valuations, large expectations, solid earnings, and growing intrinsic value. The combination of growing intrinsic value together with upward re evaluation gives us a margin of safety and also pays for the risk. Usually, we

Fund Facts

Symbol	AUXFX
Website	www.auxierasset.com
Address	Auxier Asset Management LLC 5000 S.W. Meadows Road, Suite 410 Lake Oswego, OR 97035
Tel. No.	877-328-9437
Inception	7/9/1999

Portfolio

Total Net Assets *	\$ 101.7
Avg Mkt Cap (\$ Weighted) *	N/A
Average Price/Earnings Ratio	N/A
Average Price/Book Ratio	N/A
Turnover Ratio	28 %

Investment Information

New Investment	Open
Min Initial Investment	\$ 10,000
Min Subsequent Investment	\$ 100
Min Initial IRA Investment	\$ 3,000

Risk (Against S&P 500/BARRA Val - 3 Years)

Alpha	0.04
Beta	0.74
R-Squared	0.85
Ann Std Deviation	8.03
Sharpe Ratio	1.50

Returns vs. Lipper Multi-Cap Value Index

	AUXFX	Index
1 Year (Cum.)	7.12 %	12.28 %
3 Year (Ann.)	14.81 %	19.61 %
5 Year (Ann.)	8.76 %	6.15 %

Returns vs. S&P 500/BARRA Val

	AUXFX	Index
1 Year (Cum.)	7.12 %	12.66 %
3 Year (Ann.)	14.81 %	19.89 %
5 Year (Ann.)	8.76 %	2.36 %

Fees and Expenses

Max Sales Charge - Front	0.00 %
Max Sales Charge - Deferred	0.00 %
Max Redemption Fee**	2.00 %
Total Expense Ratio	1.35 %

Portfolio Manager

J. Jeffrey Auxier	Jul-1999
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* millions ** within 6 months after purchase

Data through: 1/31/06

Source: Company Documents; Lipper



try to buy the highest quality, highest-return businesses with strong managements at bargain prices, but bargain prices often come with some negative headlines.

We're identifying these businesses ahead of time, so when there's a misperception of the true facts, we're letting the price determine our movement. If we like the business and the management and can get a cheap enough price, then we're interested. Typically, when we're buying issues that are out of favor, the price is stagnant, flat. So we're more active when the perception is negative and the bullish consensus is low.

Q: *In a sense, you're always looking for value. Is that correct?*

A: Yes. Value is getting more for your money than what you're paying, so the margin of safety represents buying at a price point that is good value, because then you have less risk on the downside and more upside as well. You're taking less risk for more reward, which has to be an oxymoron in conventional investing terms.

On March 10th 2000 people felt that tech stocks were low risk because they had done so well, but that was the highest risk time. In August 1982, when the market was trading down under 780, people thought that stocks were highly risky. A lot of this depends on a rational, businesslike, fundamental approach as opposed to keeping your ego up. It's very important to control the emotions and the ego and to make sure that you're doing the proper preparation.

Q: *What is your approach to stock selection? You probably aren't the type of investor who looks at a long monitor list on a day-to-day basis.*

A: Investing is a matter of voracious research and there is no easy formula. We look at the micro and the company-specific factors, but you also have to identify bubbles on a macro basis. I think that you have to be a historian first and study the market's behavior over 200 or 300 years. Behaviors are consistent, whether it is a new technology that's creating excitement, or a dull, mundane business, like Phillip Morris,

which doesn't go obsolete and is one of the best-performing stocks over a long time period.

You also have to study the behavior of proven wealth builders and investors. Study value investors and get on the right track by finding out who's done it with his/her own money. We also look at the big picture. Since the mid 80s, half of the globe, India and China, was all of a sudden added to the big picture. You have to factor in that there used to be three TV channels, while now you've got over 100.

So we look for businesses that won't go obsolete. Historically, everyday products like beverages, foods, tobaccos, and drugs have been long-term winners and that's what we want to see. Has technology been a long term winner? No, be-



cause of the obsolescence factor. Then you have to understand the perils of borrowed money and easy money. We look at which management is really executing at everything.

There's a lot to be said about the tenacity of doing the day-to day research. We had an exposure to Enron and got out at over \$80 mostly because of real research on the entire business. You could recognize that this was a bubble because of the easy money and the deregulation. Historically, deregulation is a bad thing as it attracts a lot of competition.

Q: *Do you think that the housing market is a bubble?*

A: Any time there is easy money, you have to be very careful. Whenever there's a lot of capital coming into one area, standards get more relaxed. Banks

have been very aggressive, particularly in Southern Californian markets. There is a lot of deregulated creative financing that enables people to buy what they cannot afford. One has to be aware that if lending is really easy, the impact can look like Calpine or Enron.

In other words, if you're buying based on price movements, not on the income you can extract from the investment, that's a speculation. A bubble or not, people are not buying real estate because of the rental income. They're just buying the easy zero. If you don't have to put any money down and have interest-only loans, you can inflate a market.

In Los Angeles, real estate from 1987 to 1997 was down 30%. The UK market dropped 30% in the early nineties. People forget that if funding gets tight, rates can stay low, but banks will start tightening lending. Things look fine until money tightens up.

Q: *Once you find all the facts and information, how do you build your portfolio?*

A: Ideally, we're trying to buy businesses that have highly recurring revenue streams and are highly predictable. We're trying to be prepared at all times for the accident or the crisis that creates the opportunity. For example, the dot-com crash was a great time. We had everything identified ahead of that, and then we knew what to buy. We were just waiting.

The key to the day-to day process is figuring out what are the fundamental trends of the economy, who's making money and what's a strong trend. A year ago, we bought Express Scripts, a pharmacy benefit manager. It does really well when drugs become generic and their margins go up. That was a function of understanding the industry, the growth of the company and how it was benefiting from the problems of Big Pharma.

The important part is doing the homework and identifying where the profits are in the economy and who's got the pricing power. Right now, in insurance you're taking potentially \$80 billion out of a \$400 billion industry, so with supply coming out, prices can go

up. But you've got to be prepared. An investment may require two years of work before the opportunity comes along but when it comes, you're there and ready.

Q: *How many stocks do you have in the portfolio and the watch list?*

A: It all depends, there's no set number. Because of global competition and the flow of capital, individual business franchises pack more risk, so we tend to be more diversified. We typically have 1% to 3% in a position and if we like it, we might take it up to 6% or 7% or maybe even 10%. Generally, if we like an industry, we'll buy more stocks in that industry. When the thrift crisis took place, we bought over 20 Southern California banks because they were all trading at 40% or 50% of book value.

A compelling opportunity will have bigger weighting, but we'd rather have a few more names just to play the odds a little better. We bought Russian oils companies with no huge position in any one of them, but they're all trading at three times earnings. We work hard to avoid the sharp downside.

Q: *You mentioned that you look for predictable earnings and revenue, reasonable growth and a stable model. Would Microsoft fall into that category?*

A: Microsoft has been a great company, but the problem is technology. There are a lot of web-based solutions, while Microsoft's monopoly is based on the operating system. When people move to the web and when there is Linux and other new technologies, the barriers of Microsoft start to break down.

Tech stocks should trade at lower valuation than other stocks because of the obsolescence factor. The tech companies from the time when I started the business in the eighties, are all gone. Dell was trading at five times earnings, Compaq was under eight times earnings, so these companies can trade down to single-digit P/Es.

Q: *How do you assess and monitor the specific risks in the portfolio?*

A: Fundamental operating risk seems to be the biggest. We also monitor the balance sheet and capital allocation risk. If the management makes big, overpriced acquisitions, that can rapidly destroy shareholders' value. There are all kinds of risk. We monitor what insiders are doing. Are they selling or buying their stock? Are they buying their stock when they should? What is their capital allocation discipline?

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about

Jeffrey Auxier

Jeff Auxier began his career at Foster Marshall-American Express (now Smith Barney) in Portland, Oregon in 1982. He became a member of the Smith Barney Portfolio Management Advisory Board, the Chairman's Council from 1990 to 1996, Senior Vice President of Investments and Senior Portfolio Management Director.

In 1998, he left Smith Barney to start his own investment advisory, Auxier Asset Management. Jeff feels privileged to manage \$400 million (as of 12/31/2005), which includes approximately \$98 million in pension consulting and the Auxier Focus Fund.

Jeff graduated with honors from the University of Oregon with a degree in Finance and an emphasis on accounting.

We are looking at the risk of foreign competition, can China come in and flood your market, for example? Is it an exciting industry that can be a magnet for capital? Is it growing so fast that there's too many entrants? How many competitors are there?

The glamour stocks, such as the plasma screen companies, attract all the excitement, competition and money, while we want to be in a dull, mundane, profitable business that just grinds out higher, sustainable sales and earnings. So 12% earnings growth rate maybe realistic, but it is hard to sustain 20% or 30% growth over 20 years.

Integrity of the management is very important. The management should love the business, not the money. Then it is important to value the strength of the franchise. Inflation also matters, because if inflation is low, the P/Es are high. We're looking at the direction of the margins as a lot of stocks trade on margins. There are a lot of variables, but you've got to minimize the variables and the risk that go into each company.

Q: *What kind of businesses do you consider less risky?*

A: We like processing businesses, such as credit card or payroll processing and the business service companies in general. We also like the educational companies because there's tremendous value added on education in this country. These businesses are far less risky than airlines or autos, for example. They don't require a lot of capital to operate and don't have huge mandatory capital spending.

Insurers can be attractive because they get paid upfront and don't have a lot of mandatory capital spending. With the free cash, the right capital allocators and low-cost, disciplined underwriting, insurance can be a good business. Banks can be good businesses if they stick to basic banking and keep the costs down. A royalty business tends to be a good business because it doesn't require a lot of investment. Overall, we look for businesses that naturally have low risk and high rates of return on invested capital. ■

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