Of Fish Ponds and Oceans

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Playing it conservative in the volatile small-cap growth fund category has earned the JP Morgan Dynamic Small Cap Fund, managed by veteran analyst Juliet Ellis, the Lipper Leader designation for both consistent performance and total return.

Q: *What are the fund's strategy, philosophy and discipline?*

A: It is a two-step approach. We view it as our mission for our shareholders to deliver risk and return characteristics that line up with the asset class. The concept behind that is we want to meet expectations and deliver on expectations. We don't want to have a small-cap growth fund that is a closet technology fund or a closet healthcare fund, for example. We view it as our goal to have a product that acts like a small-cap growth fund. The way we do that is a two-part process. We start with portfolio construction on the top down, and then we layer in a fairly rigorous stock selection process. The disciplined portfolio construction process is what gives us the risk and return characteristic of the asset class because we line up with the benchmark. A proxy for the benchmark that we use is the S&P 600 Barra Growth Index. We line our 20 economic sectors, plus or minus 350 basis points within the sectors in that benchmark. So we stay fully diversified all the time in all the sectors. We stay fully invested with very low cash levels. Maximum cash at any one time is 5%. Any time it starts to approach the 3% level, we're stepping up the due diligence on our research to add a name. That's the portfolio construction side of things. As a result, we tend to be a little more conservative as a product than is usual in this category. At least that's been my observation. When I say conservative, I mean in terms of the volatility and the standard deviation of return versus the peer group. In fact, that's really supported by Lipper, which has rated the fund on two categories in the top 20% of the universe. They call it the Lipper Leader, one for consistent return and one for total return.

Q: *I am curious about your biography. You joined Chase Asset Management in 1987. Was that when you started your career?*

A: I'm old as far as this business goes.

Q: *When you joined the firm that year, where were you situated on that fateful day when the Dow lost more than 25%.*

A: On that fateful day I was, if you could call it, in transition, because I started as a buy-side analyst with the firm in September. By October, I hadn't convinced anybody to buy my ideas. It was an interesting time.

Q: *Did you question why you were in this business?*

A: No, I didn't. It was certainly a frightening experience. My view is the last couple of years have been worse than that day. If you can collapse it into one day, it would be a lot better. On balance, my role was to do due diligence on healthcare stocks and what it did was create some great opportunities overnight.

Q: *As far as the small-cap fund goes, do you engage in any market timing of this group of 600 stocks?*

JP Morgan Dynamic Small Cap A

Fund Facts		
Symbol	VSCOX	
Website	www.jpmorganfunds.com	
Address	JP Morgan Funds, P.O. Box 219392, Kansas City, MO 64121-9392	
Tel. No.	800-348-4782	
Inception	05/19/97	
Portfolio		
Total Net Assets *		$82.30
Avg Mkt Cap ($ Weighted) *		$1,300.00
Average Price/Earnings Ratio		27.47
Average Price/Book Ratio		4.02
Turnover Ratio		57.00%
Investment Information		
New Investment		Open
Min Initial Investment		$2,500
Min Subsequent Investment		$100
Min Initial IRA Investment		$1,000
Risk (Against Std Index - 3-yr Average)		
	VSCOX	**Category Avg.**
Alpha	6.17	4.78
Beta	0.92	1.07
Returns vs. Lipper Sm-Cap Growth Index		
	VSCOX	**Index**
1 Year (Cum.)	-24.11%	-27.34%
3 Year (Ann.)	-10.21%	-17.16%
5 Year (Ann.)	1.29%	-1.45%
Returns vs. S&P 500		
	VSCOX	**Index**
1 Year (Cum.)	-24.45%	-23.02%
3 Year (Ann.)	-11.67%	-13.84%
5 Year (Ann.)	1.40%	-1.33%
Fees and Expenses		
Max Sales Charge - Front		5.75%
Max Sales Charge - Deferred		0.00%
Redemption Fee		0.00%
Total Expense Ratio		1.50%
Portfolio Manager		
Juliet Ellis		08/19/99
** millions*		*Data through: 01/31/03*

Source: Company Documents; Lipper

A: I don't want to confuse people. It's not limited to this universe. The universe of names I invest is a multiple of that because I'm limited to the benchmark in terms of my stock selection. My universe is companies in a market cap range from $200 million to $1.5 billion. It varies, but there are probably 3500 companies in that category. One of the keys is we don't time the market. One of the keys to our product is we don't time the product. We view it as our role to pick good stocks inside the small-cap asset category and to stay invested for clients at all times.

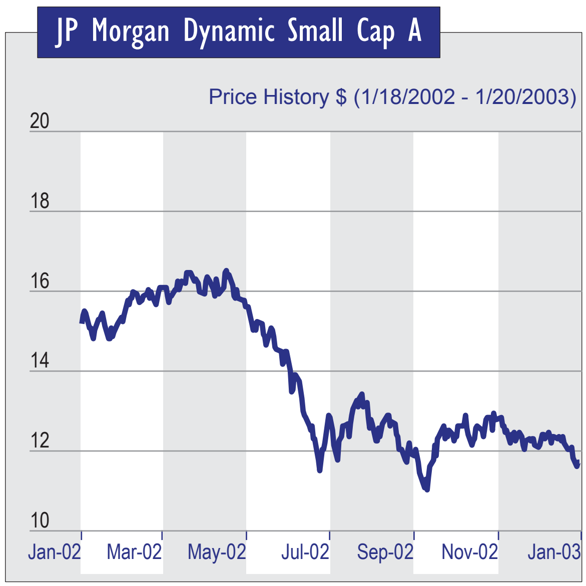
Q: How do you screen 3500 names to whittle it down to a shopping list?

A: I have a screen that I run on FactSet. That's part of our portfolio process that I mentioned. The second part of that process is rigorous stock selection, which is based on three characteristics. It's those three characteristics that I screen from the 3500 names down to a manageable list of about 100 on a monthly basis. It's a fishing pond - to take the ocean and turn it into a fishing pond. We narrow it down based on three things: good business fundamentals, reasonable valuation and attractive timeless characteristics. It is those components of those three large characteristics that make up my screen. The total number of variables is somewhere around 16 to come up with a list of names to determine what is an interesting buy today.

Q: Among the 16 measures, which ones carry the most weight?

A: They all carry equal weight. What I really do is have thresholds for which they either pass or don't pass. If they pass, and they have to pass each one of those 16, then it falls through the screen. For example, one of the characteristics is accelerating revenue growth where I take trailing quarters of revenue growth per share and compare it to the trailing 12 quarters revenue growth per share. That must be in excess of zero. So it's either yes or no. Each one of the variables in the screen is a pass or not pass. One hundred companies is a rough estimate. Sometimes it's 50; sometimes it's 150.

Q: From there, you do more diligence. What does that process entail?



A: I have a team of three analysts that work with me. It's a very rigorous due diligence process. It involves reviewing the business fundamentals of the company. The first step in assessing a company's business prospects is to develop a detailed earnings model that goes back eight quarters and goes forward eight quarters. And inside that earnings model is as much detail as we can possibly derive in terms of what makes up the sales, what's driving the sales, what kind of profitability characteristics does the businesses have, growth margins, incremental growth margins, R&D expenses. We go through the whole income statement in as much detail as we can to forecast what we think the rate of growth a company can achieve in its earnings. We do that from whatever source of information we can, which always includes management's guidance, competitors' outlooks, industry information, and finally, when relevant, Wall Street information. We've been doing this just like this for years. The idea is to gather information, assess a company's profitability outlook and make a forecast on its future. Of the kinds of companies in this universe that we like to look for, one of the key drivers is revenue growth. We like to look for companies that are driving revenue growth through any source, which would include market share gains, product introduction, propriety technology, pricing flexibility, acquisition strategies, if, and it's a lot easier in small-caps to assess this, if the management has demonstrated a track record of doing acquisitions that make economic sense, not just grow earnings and revenue by layering on by buying cheaply. Management is key. We like management to own 5% of the shares outstanding. Twenty percent is an even more attractive threshold. Inside this income statement we develop a clear picture of how fast we think a company can grow and what are its levels of earnings. If that is attractive, then that takes us to step two, which is valuation. In this style, valuation is on a P/E to growth, using our internal earnings forecast. We take that target PE based on a multiple and put it onto earnings 18 months from today. If we have 25% appreciation from today, then it's a viable idea. So the simple concept of it is we have a good business, but do we have a good stock? Valuation helps us assess that. Further, following up on valuation, the second part of that equation is what I call a reality check. In every model that we build, we have an abbreviated cash flow and balance sheet so that we then view a theoretical enterprise value to EBITDA. That exercise says, in order to get to our price target, what kind of enterprise value to EBITDA does this company trade? And that helps me quickly assess whether something is out of whack. In other words, if you have a low growth company with average profitability characteristics and the company needs a 15 enterprise value to EBITDA to get to our target price, that quickly tells me that either something is definitely changing or we're wrong on a our valuation assumptions.

Q: Do the analysts and you actually meet face-to-face with managements?

A: Whenever possible. If that's not possible, then we're on the phone with them.

Q: When a company's stock takes a dramatic rise or dip, do you get on the phone immediately?

A: It depends. There's so much fluff going on. And I think this is one of the advantages of being old is that you're a lot less scared of a stock's reaction than some other people. The reason for that is we try not to talk to IR people. We try to talk to management. That's fairly simple in the small-cap world. In some cases, they don't even have an IR department. They're very approachable. We're trying to get our information from the people that are making the decisions, not through the pipeline. I'd say, 90% of the time if a stock is down, it's readily apparent why it's down. When we call management it is we ourselves who are uncertain as to the conclusions that are being raised by the marketplace. An example might be the CFO resigns. Well, that warrants a call to see what's happening. If somebody has lowered an estimate or someone downgrades the sector group, it does not warrant a call to management. Really, every decision is dependent upon what the market is reacting to.

Q: Your fund's turnover is low relative to peers. Why?

A: We tend not to be very reactive. Compared to the universe, where the average turnover is 150%, our turnover is low because we feel like we know the companies we own, and we're trying not to react. Our time horizon is two to three years because of what we believe will materialize. If something materializes in 30 days, we will sell it. If it works out better than we thought, we'll own it for five years.

Q: What are the chief characteristics of a company that you've held for five years?

A: As long as it meets all three of our criteria, good business fundamentals, reasonable valuation, and attractive timeliness characteristics, we'll own it. At any point in time, if a company is revealing its financial condition on a quarterly basis and if we're dong a good job of picking the right stocks, those companies continue to deliver earnings growth. That's the basic concept.

Q: Some fund managers swear they never look at charts. Do you pay attention to them?

A: Yes I do. I believe that any tool that adds any measure of value to your decision-making is a useful tool. This is how I think about technicals. From my perspective, a technical chart reveals to whoever is looking at it, all the information available in the marketplace. The difficulty with technicals is you don't necessarily know what that information is. But you have all the buyers and all the sellers manifesting in the trading activity. For example, if you have more sellers than buyers, you have a declining chart, and vice versa. But if you identify large volume spikes and certain characteristics that identify a problem, you in essence have perfect information. You just don't know what it is. The first catalyst is to go back and do more homework. If you go back and do more homework and you say, I know why this stock is selling on high volume because certain players in the market think this is going to happen, but I don't, then we'll hold the stock. It's a very important differentiation. Technicals are used by different people for lots of different reasons. I'm always careful to point out I'm not a momentum guy, never was, never will be. I don't look for new highs. I don't chase stocks. I just look for information as a catalyst to have us do more homework.

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Juliet Ellis

A Chartered Financial Analyst, Juliet Ellis heads a team of three analysts that apply a rigorous search for the more than 3500 companies in the small-cap universe. She currently is a managing director of small cap equities. Prior to its merger with JP Morgan, Ellis joined Chase Asset Management in 1987. Previously she worked six years as an analyst for Merrill Lynch Asset Management.

Dave Jennings