Fundamentally Rooted

The Phoenix Small-Cap Growth Fund digs into the small-cap universe in search of the next Wal-Mart. The fund uses a fundamental process and clearly defined criteria, looking for companies with high EPS growth foreseeable for the next five years, high return on invested capital (ROIC), and sustainability. Portfolio managers Yossi Lipsker and Lou Holtz consider the long-term outlook crucial for success in the small-cap area and keep turnover low.

Q: *What is your investment philosophy?*

A: Our philosophy is strongly based on fundamental field research and heavy use of management meetings. We invest in companies with three main characteristics. First, they should be able to have above-average earnings growth over the next three to five years. The second characteristic is high or improving return on invested capital, or ROIC. Third, the companies should have some sustainable competitive advantage that will allow them to maintain the growth and the high returns on capital over a three to five year period.

Finding all three characteristics among small-cap companies is a pretty rare event. Firms like Wal-Mart were once small-cap companies with a unique business plan that generated high returns; Starbucks was once a small-cap company. We're looking for the next company that can grow from very small to very large and to hold them through their growth lifecycle.

Q: *Why do you prefer to focus on superior ROIC and superior earning growth rates? What makes those two aspects important for you?*

A: Because of the tendency of these companies to outperform. Historically, fast-range growth and high ROIC companies have outperformed consistently over five-year periods. We annually make five-year studies and the results are surprisingly similar with respect to the combination of those two factors. A company that actually grows its EPS at a 25 percent rate for the next five years, should outperform other stocks in the market.

For instance, over the last five years, the companies with ROIC of 5 to 10 percent that grew their earnings by more than 25 percent, returned 165 percent of the Russell 2000 Growth. However, those companies with a five-year ROIC of 10 to 15 percent and earnings growth of more than 25 percent, outperformed the Russell 2000 by 558 percent. That's a magnitude of almost four times, so ROIC is of primary importance to us. In essence, high ROIC is the major ingredient for having a business that ultimately returns cash to shareholders.

Q: *What gives you the confidence that the consistency of earnings growth in the historical context will continue looking forward?*

Phoenix Small-Cap Growth

Fund Facts

Symbol	PAMAX
Website	www.phoenixinvestments.com
Address	Phoenix Investment Partners 56 Prospect Street Hartford, CT 06115
Tel. No.	800-243-1574
Inception	10/10/1994

Portfolio

Total Net Assets *	$ 178
Avg Mkt Cap ($ Weighted) *	$ 1,100
Average Price/Earnings Ratio	26.75
Average Price/Book Ratio	3.62
Turnover Ratio	38 %

Investment Information

New Investment	Open
Min Initial Investment	$ 500
Min Subsequent Investment	$ 25
Min Initial IRA Investment	$ 25

Risk (Against S&P 500 - 3 Years)

Alpha	-0.23
Beta	1.66
R-Squared	0.66
Ann Std Deviation	17.47
Sharpe Ratio	1.32

Returns vs. Russell 2000 Growth Index

	PAMAX	Index
1 Year (Cum.)	29.94 %	27.84 %
3 Year (Ann.)	26.67 %	28.14 %
5 Year (Ann.)	6.35 %	8.59 %

Returns vs. S&P 500

	PAMAX	Index
1 Year (Cum.)	29.94 %	11.73 %
3 Year (Ann.)	26.67 %	17.22 %
5 Year (Ann.)	6.35 %	3.97 %

Fees and Expenses

Max Sales Charge - Front	5.75 %
Max Sales Charge - Deferred	0.00 %
Max Redemption Fee	0.00 %
Total Expense Ratio	1.58 %

Portfolio Manager

Yossi Lipsker	5/1/2000
Lou Holtz	1/31/2001

** millions*

Data through: 3/31/06

Source: Company Documents; Lipper

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A: We run the historical study agnostic to stocks; we're just looking at the growth, the ROIC, and the returns. The companies that will generate higher earnings growth and ROIC over the next 5 years, are likely to be very different from the ones in the past five years, so we're looking prospectively. If our fundamental analysis determines with a high degree of conviction that a company can grow earnings at a fast rate and achieve a high ROIC, there is a strong chance that it will be in our portfolio.

Q: ***How do you implement that philosophy into an investment strategy and process?***

A: Our strategy is to investigate small-cap companies and identify those that meet our three unique characteristics. It's not an easy task, and it requires a lot of work, patience and face-to-face meetings with management teams. It also requires an understanding of how each of these businesses makes money, because only in that way can we get comfortable with an investment and make a long-term purchase. Our team includes myself, Yossi, and a few analysts, Andrew Srichandra and Derek Johnston.

We have a disciplined process that starts with a universe of companies with market cap from $100 million to $2.5 billion. Within this universe, we conduct an industry analysis to determine whether the specific industry can support a company with high earnings growth and ROIC. Then we spend the majority of our time on company analysis, where we try to get to the essence of the company, of its competitive advantage, and to estimate where ROIC can go over the long run.

Once we get comfortable with that, it comes down to a valuation analysis. It can be the greatest business in the world, but it may not be attractive for current purchase. We measure all the companies that fit our criteria relative to existing names in the portfolio and, if valuation is incrementally better than something we own in the portfolio, we'll swap out.

Q: ***How do you approach portfolio construction?***

A: We keep the portfolio to less than 100 names, currently it's about 70 names. We have three major groups of companies: traditional growth names, aggressive growth names and balanced/safe havens. Traditional growth names, which represent about 40 to 80 percent of the portfolio, are companies with EPS growth of 20 percent or more over the next 3-5 years, high ROIC and some type of sustainability.

Aggressive growth names, which constitute about 10 to 30 percent of the portfolio, are the companies that are probably a little bit earlier in their lifecycle than the growth names. They may not be generating a higher ROIC today, but we expect strong growth over the next 3-5 years in both earnings and ROIC.

From a risk-control perspective, we make sure that we're not taking up too much risk by limiting the aggressive growth names to 30 percent of the portfolio. However, we also want to make sure that we're not burying our heads in the sand, so we have a minimum of 10 percent in aggressive growth to benefit from companies that can provide those types of returns over a 3-5 year period.

The third category, the safe havens, are companies with dominant franchises, high ROIC, and excess cash flow returns. However, these companies are growing with less than 20 percent; the growth is usually in the mid-teens. They are going to be more stable than the other two areas and they represent only 10 to 30 percent of the portfolio.

Q: ***What is the turnover of the fund?***

A: Our turnover rate makes us notably different from typical small-cap growth managers. Over the last three years, we've averaged less than 40 percent turnover. It truly is a buy-and-hold portfolio as compared to other managers who can have turnover of more than 100 percent.

The one thing we know is that turnover in the small-cap area is very, very expensive relative to other asset classes. In the large cap area, there's a fairly decent liquidity in most of the names and the portfolio managers don't lose from moving the market. In the small cap area, when buying and selling, the costs can be up 8 to 10 percent, or the entire potential annual total return, for a particular stock. High turnover really eats away returns, so we take that very seriously.

Q: ***In your experience, what are the particularities of the small-cap growth area?***

A: Over time, the small-cap growth asset class has been a wonderful asset class to be in. Small-cap returns compound at a higher rate than the other asset classes, such as large-cap growth stocks or large-cap stocks in general. However, investors should understand that the good long-term returns inherently go with more volatility. The investors that truly have a long-term outlook will greatly benefit from being in the asset class.

For the last 3 to 4 years small caps have done relatively better than other asset classes, such as large caps. The profit recession in 2001 affected all companies, but it affected small-cap companies more than large-cap ones. They fell further and, if you think about it, that makes sense. Large-cap companies have a large base of revenues to spread expenses across, and inherently, are less volatile.

However, small-cap companies have been able to adjust their cost structures to drive a rebound in their profit margins and that has fueled earnings growth over the last few years. Today, both small- and large-cap companies are in line with their long-term averages in terms of profit margins. I don't anticipate that type of rebound effect going forward, but we're left with a lot of good small-cap companies that dominate their particular businesses

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and have good revenue growth rate plans. This should drive revenue and earnings a bit faster than for the large-cap growth side. In essence, we see a good probability that small caps will continue to do well for the next 3-5 years.

Q: ***Technology and healthcare are very diversified sectors. Could you give us a few examples of specific stocks?***

A: In the technology area, ARM Holdings (ARMHY) is a good example. We came across this company in connection with Artisan Holdings, which was ultimately purchased by ARM. ARM is in the business of providing semi-conductor intellectual property, or IP, which were typically handled internally by firms. This represents the next evolution of the entire business, where IP can be outsourced and leveraged as one or two companies provide the essential building blocks, or core architectures, needed for semi-conductor design.

ARM has come to dominate the semiconductor IP industry, growing at a faster secular rate than the overall semi-conductor industry, which is also growing at a rate north of the GDP. Inherently, it has strong growth characteristics since it's become a standard in the industry. For instance, there's a 90 percent chance that your cell phone is based on ARM architecture. If the semi-conductor manufacturer design team wants to have a component within a cell phone, it's essential for them to design to ARM standard, so the company is in a very good competitive position to allow sustainability of returns and growth over time.

In terms of ROIC, the company carries approximately 35 percent operating margin and we believe that's moving north. The business requires very little capital expenditures, so they have very strong ROIC and strong sustainability characteristics due to their competitive advantages.

Q: ***Many of the outsourcing companies from Israel or India, like Cognizant or Infosys, have similar margins and little capital requirements for their growth. Do these companies meet your criteria? In fact, Infosys has a higher net margin than Microsoft.***

A: Many of them do and some are outside of our market-cap ranges, but you're right, they have the ability to do that. Within software, we have some unique names, such as Blackboard, a company that provides software to the higher education market. In essence, schools will use its software to allow professors to put their lesson plans on the system for students to access. It dominates its business and has a high level of recurring income because it would be very painful for schools to replace the software system.

> "Return on invested capital (ROIC) is of primary importance to us, especially when compared to other investment managers. In essence, ROIC is the major ingredient for having a business that ultimately returns cash to shareholders."

Lou Holtz

Yossi Lipsker

about The Team

Lou Holtz, portfolio manager, has spent 10 years in the money management industry as an analyst and portfolio manager. Holtz holds a Bachelor of Arts degree in business economics with honors from the University of California, Santa Barbara and an M.B.A. He has earned the right to use the Chartered Financial Analyst designation and is a member of the CFA Society of Los Angeles (CFALA).

Yossi Lipsker, portfolio manager, received an M.B.A. with an emphasis in finance from Columbia Business School. While at Columbia he excelled academically, gaining membership in both the Beta Gamma Sigma Honor Society and the Dean's List. He has earned the right to use the Chartered Financial Analyst designation and is a member of the CFA Society of Los Angeles (CFALA).

Q: ***A company that makes money through upgrade cycles because you just don't throw away your Intuit from the accounting system.***

A: Yes, if Intuit or Adobe were small-cap businesses, they would most likely fit our criteria, especially from a ROIC standpoint. But in the small-cap software area, that's a bit tougher. We deal with less established businesses. But if we can find a company with the ability to be the next Adobe or Infosys, then we take a hard look at it.

A year or two ago we owned Macromedia, which provides Flash technology. It was ultimately bought out by Adobe. It had a dominant market position, generated very high cash flow returns, high ROIC, and was in a very sustainable position because so many developers developed to the Macromedia Flash standard. That is a typical software/technology company for us.

Q: ***Can you give us an example in the consumer discretionary area?***

A: Lifetime Fitness would be a good example. This is a health club company similar to the likes of a 24-Hour fitness center, but it differentiates itself through a large-box concept with a moderate membership price. It provides members with a combination of sports, family recreation and spa resort characteristics. It's really a destination for families, which resembles a mini country club for the middle class.

They've had tremendous success with this concept. The ROIC is very high and when they ultimately get to full capacity, the margin can be north of 50 percent. The key there is having success in generating the traffic. Now it's a matter of execution and roll out. If they are successful at this part, we can see the company generating very large amounts of cash for their shareholders. ▮

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