

# Valuable Inefficiencies

**F**or Michael J. Chren, team leader for the Allegiant Asset Management Large Cap Value equity styles, value investing is a superior strategy because though markets tend to be efficient over the long term, it is critical to take advantage of short term pricing inefficiencies. His strategy does just that. Value stocks are not necessarily those with low P/Es, but those trading at least 25% below their intrinsic value. The critical variable is how to measure intrinsic value.

**Q:** How would you describe the investment philosophy of your fund?

**A:** There are three parts to our philosophy. First, we firmly believe that value investing is a superior way to invest. By value investing, I mean purchasing investment securities trading at significant discount to their underlying intrinsic value; it doesn't necessarily mean buying only low P/E stocks, or high dividend yield stocks, or low price/book stocks. We look at every security and every company from an intrinsic value perspective, so the label "value" or "growth" is not as important as our conclusion if the stock is trading at significant discount.

The second part is that we believe that the market is extremely efficient, but investors do overreact in the short and intermediate term. That creates opportunities we can capitalize on. We may use the same sources of information with many investors, but what sets us apart is the knowledge about the long-term efficiency of the market, its small pockets of inefficiency,

and the recognition that investors have a tendency to overreact.

The third part is that most investors are looking for the same thing: consistency, predictability, and superiority in investment returns. We recognize that as a cornerstone of our philosophy, so we aim to provide to our clients what they expect, in the form of a risk-controlled large-cap value portfolio.

**Q:** Since risk control is an important part of your philosophy, would you explain how you approach it?

**A:** We use risk controls at various levels of the portfolio. Overall, we're not looking for homeruns; we prefer to hit singles and doubles in a consistent fashion.

At the portfolio level, we limit cash to 5%, but we're actually fully invested. For example, currently our cash level is less than 1%. If an investor gives us money to invest in attractive large-cap value stocks, it is our obligation to be fully invested in such stocks at any point of the market cycle. The other reason we hold little

## Allegiant Large Cap Value

### Fund Facts

Symbol	AEIX (I Shares)
Website	<a href="http://www.allegiantfunds.com">www.allegiantfunds.com</a>
Address	Allegiant Funds 760 Moore Road King of Prussia, PA 19406
Tel. No.	800-622-FUND (3863)
Inception	7/1/1994

### Portfolio

Total Net Assets *	\$ 645
Avg Mkt Cap (\$ Weighted) *	\$ 88,200
Average Price/Earnings Ratio	14.61x
Average Price/Book Ratio	2.35x
Turnover Ratio	37 %

### Investment Information

New Investment	Open
Min Initial Investment	\$ 0
Min Subsequent Investment	\$ 0
Min Initial IRA Investment	\$ 0

### Risk (Against S&P 500 - 3 Years)

Alpha	4.38 %
Beta	0.96
R-Squared	83 %
Ann Std Deviation	8.04 %
Sharpe Ratio	1.68

### Returns vs. Russell 1000 Value IX

	AEIX	Index
1 Year (Cum.)	16.78 %	12.61 %
3 Year (Ann.)	15.99 %	15.93 %
5 Year (Ann.)	6.32 %	6.28 %

### Returns vs. S&P 500

	AEIX	Index
1 Year (Cum.)	16.78 %	8.64 %
3 Year (Ann.)	15.99 %	11.64 %
5 Year (Ann.)	6.32 %	1.96 %

### Fees and Expenses

Max Sales Charge - Front	0.00 %
Max Sales Charge - Deferred	0.00 %
Max Redemption Fee	0.00 %
Total Expense Ratio	0.94 %

### Portfolio Manager

Team Managed	---
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\* millions

Data through: 5/31/06

Source: Company Documents; Lipper



cash is that we don't believe in market timing.

We have a target tracking error of 3% to 7% relative to our benchmark, Russell 1000 Value index; currently we're towards the lower end of the range.

At the sector level, we have constraints on the size of the weight we hold in any given sector of the Russell 1000 Value index. We classify the sectors in three separate categories according to their size and have different limits for each category. The purpose of the system is that we do make mistakes, like all investors do, but it's important to recognize those mistakes and to limit their impact on the portfolio.

Finally, at the individual position level, we have a maximum absolute position size of 500 basis points and a relative maximum position size of 250 basis points overweight relative to the index. That strategy can hurt us in situations where the market is being dominated by a handful of sectors; however, in broad-based markets where all the sectors participate, we tend to outperform the market, especially if the sectors which were out-of-favor trade up.

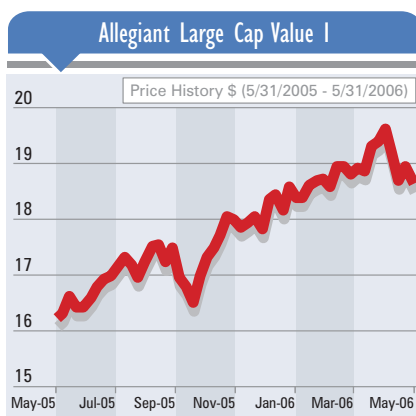
**Q:** *What are the milestones of your investment strategy and process?*

**A:** We have a four-step process, which consists of (1) defining the universe, (2) ranking the stocks, (3) conducting fundamental research, and (4) assembling a portfolio following our parameters. Our investment universe includes all domestically-traded stocks with market cap of at least \$3 billion. This comprises about 1,200 stocks.

The second step sets us apart from a lot of other value investors. Instead of screening, we rank the entire universe from one to five, one being the most attractive. The scoring system looks at several key variables and weights them to create a score. The key driver is free cash flow yield, but we also look at the management's use of capital, senti-

ment and the market reaction to the particular stock at a given point of time. After ranking the whole universe, we focus on the most attractively ranked stocks in the model, roughly the top half of the ranking.

The third step is good old-fashioned fundamental analysis and bottom-up research, and that's where we spend 90 percent of our time. This is stock-specific research and our sector weights are driven by this bottom-up research. For instance, if we find a lot of large healthcare stocks that we like in that process, we would be overweight in healthcare, but it's not a top-down decision of liking or disliking entire sectors.



Our fundamental research is driven by what we call attractive valuation and improving dynamics. Basically, a stock has to be trading at a significant discount, 25% or greater, to its intrinsic value. Improving dynamic is the possession of a catalyst that will provoke change. Once we identify the combination of attractive valuation and improving dynamics, these become potential investments for the portfolio. Usually we have isolated about 100 to 150 candidates.

In the fourth step, portfolio construction, we apply the constraints I explained earlier. Our portfolio consists of 60 to 70 stocks. We currently own 68.

**Q:** *What are the important steps of your research process?*

**A:** Our fundamental research begins with the calculation of intrinsic value, in order to identify candidates with attractive valuation; we look at intrinsic value three different ways. First, we do a tangible net equity calculation, in which we go through the balance sheet to get an idea if a stock is trading at a discount to tangible net equity. Typically, few companies do, but if we find some, we'll continue to look at them. Of the three ways that we look at valuation, that's certainly the smallest one.

The second calculation is proprietary discounted cash flow (DCF) analysis, which is a conservative approach to valuing companies. The criticism of most DCF models is that you can manipulate the end result. Our approach uses both the company and the Street as sources of information. We know that both of these sources are usually overly optimistic, so we temper that with our own experience and to build estimates of future growth which discount that optimism. In the end our forecasts are pretty conservative, so if we still find a stock trading at a big discount on a DCF basis, then we'll certainly consider buying it, assuming that the improving dynamics are in place.

The third part of the valuation analysis, which we call strategic private market value, also sets us apart from other value managers. This is the value of a franchise to a strategic buyer, and it becomes increasingly important when companies are trading at extremely depressed valuation levels or are in consolidated industries. We often find the value of the franchise is generally quite a bit more than what the market is anticipating, and also above what a typical DCF model will dictate.

After assessing valuation from three separate perspectives--tangible net equity, discounted cash flow, and strategic private market--we look for stocks that are minimum 25% discounted.

But valuation is not the only guide. Before we buy a stock, we also need to see improving dynamics, and the combination of attractive valuation and improving dynamics is really powerful. Assuming that we're correct in the valuation work and in the assessment of the dynamics, more often than not the stock will outperform.

To illustrate improving dynamic: Oftentimes, a company may have really lulled the market to sleep so that people have become disinterested. But often there will be a significant change, such as a new management team, and the company institutes a renewed focus on improving operating positions, generating higher growth and focusing on shareholder interest. This is an improving dynamic and it is what we're trying to find to couple with the attractive valuation. Typically, the names would fit the classic turnaround story would include Office Depot, Aon Corporation and a handful of others.

**Q:** *Could you give us some examples where your strategy helped you successfully identify stocks, and some where it didn't play out so well?*

**A:** Aon would be a great example. If you look back at the history of this company, Aon is one of the largest insurance brokers in the world and number one in Europe. Marsh & McLennan is the number one broker domestically, but worldwide Aon is number one. Despite this, the company traded at a discount.

We saw attractive valuation in the name, coupled with improving dynamics highlighted in a new management team and Aon's decision to exit the underwriting business and focus on brokerage operations. Programs were implemented to expand margins and cut costs in the brokerage operation. They also cut contingent commissions, a critical factor in the insurance business. The market sold off the name over fears that margins were

going to permanently be impaired, but it was an overreaction. Instead, Aon's actions forced their biggest competitors to change the way they did business, which ultimately benefited Aon with bigger market share. Profitability began to improve, as did pricing in the property and cash lines.

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about

**Michael Chren**

**Michael J. Chren, CFA**  
**Sr. Director, Large Cap Value**

Mr. Chren is team leader for the Allegiant Asset Management Large Cap Value equity styles. Michael joined the firm in 2003 and has 20 years of investment experience. Most recently with INVESCO Capital Management, he served as Partner/Senior Portfolio Manager for the firm's \$1.0 billion Fundamental Value equity style offerings. Prior to his INVESCO responsibilities, Michael served as Senior Portfolio Manager with DePrince, Race and Zollo, where he co-managed large cap value equity assets in excess of \$1.2 billion. A CFA Charterholder, Michael holds a BA from Yale University, a Master of Architecture from Yale University, and an MBA from Carnegie Mellon University.

The stock went from the low- to mid-20s up to the 40s.

An example of a name that didn't work as well is Coca-Cola. Our original thesis included several powerful measures playing out, including an internal cost-cutting program. Some of these have happened, but the market's reaction has been lukewarm, especially in the face of other corporate issues.

**Q:** *What is your advantage over other Value managers?*

**A:** My background is actually in architecture, which I think is excellent metaphor for the investment business. Architecture is a blend of art and science; buildings need to be structurally sound, as well as pleasing to the eye. Investing is similar, it is a blend of art and science. The science is the valuation process, which we uniquely approach using three different methodologies. The true value added is in the art of security selection and portfolio management: this is the timing, experience, and ability to assess the impact of things that can't be quantified. We're different because we recognize this.

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

**A:** Our turnover is pretty low relative to the average investor, as well as to other large-cap value investors. Right now it is between 30% and 35% a year. As we just discussed, our process is focused on finding companies at an attractive valuation with a catalyst for change. If a stock is selected for inclusion in the portfolio, we are confident in its long-term prospects, so this leads to lower turnover. We tend to sell securities when they reach our estimated value. Our multi-calculation valuation process is a critical factor and it has proven successful over the length of our track record. ■

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