

Pure Small Cap Growth

Small-cap growth investing poses specific challenges to investors, such as higher volatility, lower liquidity, and less readily available information. Ken Korngiebel, the manager of Columbia Small Cap Growth Fund I, believes that the crucial factors for success include a longer-term horizon, a research team with diversified perspectives, valuation of both upside and downside potential, and risk management in which every bet is intentional.

Q: What is the investment philosophy of Columbia Small Cap Growth?

A: We're definitely growth oriented investors. We're looking for companies that participate in higher-growth markets and therefore have higher earnings growth rates. We're also looking for mispricings within the growth universe because we want to combine high earnings growth with the prospect for a rising valuation. It's that combination that leads to potentially superior investments if you've done your analysis and your valuation work correctly.

The investable universe for this small-cap product ranges from about \$200 million to \$2 billion market cap. I manage the fund on a weighted average market-cap basis, so the fund is pure both in terms of the style and capitalization.

We're looking not only for companies participating in a higher-growth market, but also for companies taking share within that market. That gives us an idea about management's ability to execute and about the differentiation they have against other players. It doesn't necessarily mean owning one stock within a high-growth market, but it means being aware of who's growing faster within that market.

Two factors of considerable importance to use are a company's organic growth rate and its capital efficiency. Ultimately, the organic growth rate of a company is limited by its ability to generate its own cash to fund this growth. As a result, we tend to avoid companies that are dependent on the capital markets to sustain their growth. In terms of business models, we look for capital-efficient businesses. An important issue is how much capital needs to be invested to generate a dollar of income.

Q: Why do you believe that investors should pursue the small-cap growth asset class, which is usually associated with better reward, but also with higher volatility?

A: Time horizon and the need to access one's capital are important factors in asset allocation decisions. Historically, small cap stocks have delivered greater returns over time than large cap stocks, but with greater volatility. To get the benefit of these greater returns, you need to have a long enough holding period in order to withstand the high volatility that can occur over shorter time horizons.

Additionally, a strong argument can be made that active management adds

Fund Facts

Symbol	CMSCX
Website	www.columbiafunds.com
Address	Columbia Funds One Financial Center Boston, MA 02111-2621
Tel. No.	800-426-3750
Inception	10/01/1996

Portfolio

Total Net Assets *	\$ 220
Avg Mkt Cap (\$ Weighted) *	\$ 1,567
Average Price/Earnings Ratio	29.35
Average Price/Book Ratio	4.36
Turnover Ratio	114 %

Investment Information

New Investment	Open
Min Initial Investment	\$ 1,000
Min Subsequent Investment	\$ 50
Min Initial IRA Investment	\$ 0

Risk (Against Russell 2000 Growth IX - 3 Years)

Alpha	0.17
Beta	0.94
R-Squared	0.92
Ann Std Deviation	16.02
Sharpe Ratio	0.39

Returns vs. Russell 2000 Growth Index

	CMSCX	Index
1 Year (Cum.)	50.23 %	36.13 %
3 Year (Ann.)	25.18 %	24.22 %
5 Year (Ann.)	7.74 %	6.05 %

Returns vs. S&P 500

	CMSCX	Index
1 Year (Cum.)	50.23 %	15.42 %
3 Year (Ann.)	25.18 %	14.68 %
5 Year (Ann.)	7.74 %	2.70 %

Fees and Expenses

Max Sales Charge - Front	5.75 %
Max Sales Charge - Deferred	5.00 %
Max Redemption Fee	0.00 %
Total Expense Ratio	1.31 %

Portfolio Manager

Kenneth Korngiebel - Lead PM	6/30/2004
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* millions

Data through: 4/30/06

Total net assets as of 3/31/06

Source: Company Documents; Lipper



value in the small-cap area. This holds true for both growth or value strategies.

Q: *How does your strategy differentiate you from other funds in your space?*

A: Many small-cap managers are stock pickers who manage a collection of stocks. We see three different layers of alpha – fundamental research, valuation, and portfolio construction.

Structurally, we organize our fundamental research along industries, with some overlapping coverage. For example, one person is primarily responsible for energy, but two other people are quite conversant in energy, so the system of primary coverage is reinforced by our broad backgrounds to get multiple perspectives within industry groups. Over time, our vertical structure has resulted in information networks consisting of people in industry, senior-level management teams, people on Wall Street, and other investors. We derive proprietary research from that information network. That's core to what we do.

The second aspect is the valuation work. In a growth universe, the value of a security is more dependent on future cash flows, and therefore, expectations for future performance are reflected in the stock price. Those expectations change and create volatility, an environment where valuation becomes a crucial guide. Without that framework, you'd be navigating the investment universe without a compass or a map, and you can easily get pushed around by price action. Valuation informs our entry and exit points.

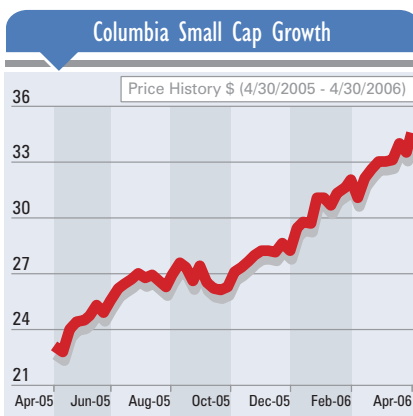
The people on the team have a pretty good sense of risk and reward and translating that into upside and downside valuation. We're calculating not only the price target for the upside, but also the downside if things don't go as planned. The result is a risk/reward spectrum for each particular security.

When that is aggregated, we get into portfolio construction and allocation of capital, which is the third layer of our work. I don't think the majority of small-cap managers are spending that much time on capital allocation, so I believe that's a differentiating factor within the small-cap universe.

Finally, I can create an investment process around a guiding philosophy, but I can't strive for consistently superior results without great talent. I work with five talented people, most of whom have been in the business for eight to ten years. Three of them, in addition to being great fundamental analysts, have portfolio management experience in their own right.

Q: *What type of growth do you base your decisions upon? How far into the future or history do you look at?*

A: We're growth investors so we are looking prospectively and trying to understand what the earnings power of a company will be over the next 12, 24, 36 months. When a company reports a dis-



appointing number today, people's perceptions of its sustainable earnings growth can change. We need to see if that makes sense. Proper research and valuation could lead us to conclude that we'll get adequate return on the stock based on a different conclusion about the company's earnings power over the next two and three years.

The difference in horizons is why we think a time arbitrage exists. I think that has become more important over the last several years because of the rapid increase in alternative investment vehicles, particularly hedge funds, which can be driven by shorter-term time horizons.

Q: *What kind of quantitative parameters do you consider in the small-cap area, where the information is not as readily available as in the large-cap area?*

A: That's a good question. We have a very extensive universe of potential investments. Because of that, we engage in systematic screening of both our holdings and potential investments. From a historic perspective, the quantitative aspect is a change for this product, but to sort through a universe of more than 1,000 possible investments with six people, you have to know what you're looking for.

The filters we use keep us focused on the factors we consider important rather than responding to someone else's agenda. Our models rank the universe by quintiles of attractiveness. The factors we consider important fall in three general categories: quality, valuation and catalysts.

Q: *Can you give us some examples of how your process helped you to select certain stocks?*

A: Cognizant Technology is a stock that we purchased back in the summer of 2002, when people thought that demand for IT was falling apart. At the same time, there was some controversy about the future margins of the business because of worries about the response of larger competitors who stood to lose market share. But the stock appealed to us because of the huge market potential. You only had to look at the number of total consultants and the pricing of their services relative to the value delivered, to see the enormous potential for a lower-cost competitor to take share.

Cognizant also has a business model that was capital-efficient and highly cash-generative. The other aspect was the labor pool, which consists of an English speaking, educated, and very technically-skilled population. We also looked at Cognizant's vertical markets, key accounts, and at how deeply they could penetrate these accounts. Then we made projections by verticals and by potential customer within these, and arrived at some fairly large numbers.

We don't own the stock now in the small-cap portfolio because its market cap grew to about \$8 billion, but we still hold it in some of our other products.

Another example would be Resmed, which we have held for a long time. It's a

company I've known for 10 years. The market they participate in has historically grown 20% per year. We looked at the gross margins, because that's an indicator of the value added, and the margins run in the 60% to 65% range. So it's a profitable business. Of equal importance, Resmed generates a tremendous amount of operating cash flow relative to net income, so they have been able to fund expansion out of their cash flow, not through a credit line.

The company's devices and masks address the sleep apnea market. Sleep apnea is highly correlated with obesity and very under-diagnosed. There is a strong and growing body of evidence that sleep apnea contributes to heart disease and stroke, among other things. Resmed is an R&D leader and I've watched them go through a number of product cycles. They've often been the first to innovate a new mask or a new pressure device that is smaller, quieter, or more efficacious.

The industry has consolidated and become a two-horse race between Resmed and one other company, both of which managed to distance themselves for a number of reasons. In Resmed's case, they're a thought leader within the medical community and have superb R&D. Their competitive advantages map onto an under-diagnosed disease within a growing population of overweight people. Ultimately, it meets the requirements of being in a big, fast-growing market, having a capital-efficient business model, and having visibility on sustainable growth for a period of time.

Q: *What are the benchmarks of the portfolio construction process? What is the number of stocks that you own, the exposure limits, and the turnover?*

A: Our portfolios hold between 100 and 150 stocks for purposes of diversification and liquidity, which is a big issue in small-caps. In that area trading volumes are lower, so when you're buying or selling stocks, you have to consider the price impact on the market that may erode the alpha between the idea generation and the execution. If you're trying to put a lot of money to work, you'll im-

pact the price, unless you're doing it at news events, which is when information gets priced into the stock and liquidity happens.

Another reason for the relatively large number of holdings is that we want the returns to be sustainable as assets scale. From inception, the process and portfolio construction were designed to appeal to sophisticated clients who would want

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about

Ken Korngiebel

Kenneth Korngiebel is a senior vice president for Columbia Management and the lead portfolio manager of small, small/mid and mid cap growth portfolios. Prior to joining Columbia Management in 1996, he held positions in private equity and commercial real estate.

Mr. Korngiebel earned a BA degree in economics from Stanford University in 1987 and an MBA in finance from the Wharton School at the University of Pennsylvania in 1996. He devotes full time to portfolio management and securities analysis. He is a member of the Portland Society of Financial Analysts.

the manager to be able to handle a bigger asset base. The returns we've generated aren't the result of a highly concentrated, nimble product resulting from a low asset base.

We compete against the Russell 2000 Growth Index and our sector over- and underweight tend to be less than 500 basis points around the index weights. The target tracking error for the portfolio is 4% to 8%. About 80% of that is attributable to stock selection and 20% to sector over- and underweights, so the majority of our performance comes from stock picking.

The turnover rate is approximately 100%, but the name turnover is lower than the dollar turnover because we trade around positions. We have both upside and downside price targets, and we think about how much we want to own along that spectrum. It's basically owning more towards the downside and less toward the upside. We tend to trade around positions when stocks become temporarily overvalued or undervalued within the context of longer-term solid investment opportunities.

Q: *What are your views on risk controls?*

A: I'm very focused on risk management. This gets reflected in how much of a stock we own at any given price, how much we own given the volatility, what active weights we have, and how diversified the portfolio is. We also do risk assessment along many different factors, such as currency exposure or exposure to size, to name a few.

We have a set of analytical tools that help us monitor risk in real time and more extensively than just looking at sector exposures. Our quantitative strategies group has built tool sets to drill down into our portfolios and help us understand if we have, for example, a currency or interest rate bet.

The general idea is that we don't want any unintended bets in the portfolio. Everything is intentional, which doesn't mean that we'll always be right, but we're making investment decisions that are clearly informed by what the risks are. Unintended bets may cost you a lot more than you expected. ■

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