

# Contrarian In Search of Value

*The Fifth Third Discipline Large-Cap Value fund exploits the tendency of the market to price stocks based on an extrapolation of recent results. In fact, growth rates exhibit little persistence over time, so that buying out-of-favor, low expectation stocks with low P/E's, low price to book ratios and above average yields is a winning strategy.*

## Q: What is the investment philosophy of the fund?

**A:** We are value investors and we are contrarians. What makes this approach rewarding is the tendency toward mean reversion of return on investment and earnings growth. The reason for this is that high returns on investment tend to attract capital, which in turn tends to drive returns down. Low returns on investment tend to drive capital out, and as a result, return on investment rises.

In spite of those cycles, investors extrapolate the recent past and price the stocks accordingly. They assume that companies that have not been successful recently in terms of their profitability and earnings per share growth rate are not going to be successful in the future, and they assign a low P/E ratio to those companies. Yet, when this reversion to the mean occurs and profitability and earnings growth rebound, the P/E ratios rise, providing the reward for value investors.

## Q: Do you think along sector lines or along the lines of capitalization? In general, what type of stocks are you looking for?

**A:** We're interested in stocks of companies with market cap of \$4 billion or more, and we have some constraints that require exposure in all of the ten economic sectors.

We're looking for stocks that are statistically cheap and undervalued and, ideally, which have a positive catalyst. 'Statistically cheap' means low P/Es, low price-to-cash flow, low price-to-book value, and higher yields. Undervalued means stocks that are selling for less than our estimate of their intrinsic value. By positive catalyst I mean something that's going to get investors excited. It could be a new product, a new management, a new strategy, or simply rising Wall Street earnings estimates. For a cyclical stock, it could be our conviction that the economy will expand.

## FUND FACTS

Symbol	<b>FEINX</b>
Website	<a href="http://www.ftam.com">www.ftam.com</a>
Address	Fifth Third Asset Management, Inc. 38 Fountain Square Plaza Cincinnati, OH 45263
Tel. No.	800-282-5706
Inception	1/27/1997

## PORTFOLIO

Total Net Assets *	\$598.9
Avg Mkt Cap (\$ Weighted) *	\$66,900
Average Price/Earnings Ratio	13.1
Average Price/Book Ratio	2.1
Turnover Ratio	31%

## INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$1,000
Min Subsequent Investment	\$50
Min Initial IRA Investment	\$500

## RISK (AGAINST S&P 500 - 3 YEARS)

Alpha	3.18
Beta	1.07
R-Squared	0.85
Ann Std Deviation	8.89
Sharpe Ratio	1.48

## RETURNS VS. RUSSELL 1000 VALUE INDEX

	FEINX	Index
1 Year (Cum.)	11.96%	12.10%
3 Year (Ann.)	15.43%	15.70%
5 Year (Ann.)	7.53%	6.90%

## RETURNS VS. S&P 500

	FEINX	Index
1 Year (Cum.)	11.96%	8.63%
3 Year (Ann.)	15.43%	11.22%
5 Year (Ann.)	7.53%	2.49%

## FEES AND EXPENSES

Max Sales Charge - Front**	5.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee	0.00%
Total Expense Ratio	1.32%

## PORTFOLIO MANAGER

James R. Kirk	Aug-2002
Mary Jane Matts	Jul-2005

\* millions \*\* for amount invested less than \$50,000

Data through: 6/30/2006

Source: Company Documents; Lipper



**Q: How do you determine that a stock is undervalued?**

**A:** We use a number of valuation models, but all of them are driven by three things. The first is an estimate of normalized EPS; the second is an estimate of long-term EPS growth; and the third is an assessment of risk. Those three things are the focus of all the fundamental analysis we do - all the 10Ks we read, the numbers we crunch, the research reports we read, the conference calls we listen to.

The estimate of normalized earnings is something that we spend a lot of time on. We start by looking at history, at least ten years. We look at reported earnings and return on equity. Then we break return on equity down into net margins, asset turnover, and financial leverage. We think about what may have changed, why, and if it is a permanent or a temporary change.

We have five people on the large cap value team with an average experience of 21 years. All of us are CFAs and four out of the five have an MBA. The fifth person is a CPA, which is helpful with all the accounting issues today.

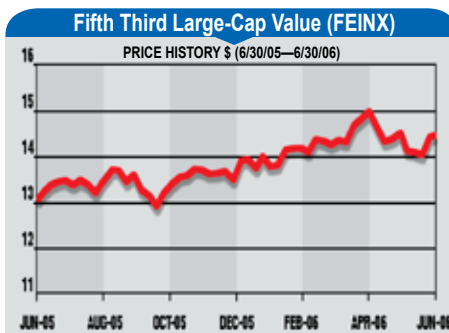
**Q: Which benchmark you measure yourself against and how would you define your perception of value? Do you look for turnaround situations, for example?**

**A:** It's the Russell 1000 Value Index. Certainly, we end up buying a lot of turnaround situations. I'm never entirely sure what people mean by 'deep value' and 'relative value,' but we do have some stocks that everyone would agree are deep value. We are not relative value in the sense some people mean it. If, for example, in the tech sector there are very few stocks that are cheap relative to the overall market, many investors would buy stocks that are cheap relative to other tech stocks. We don't do that. We want statistical cheapness relative to the overall market, which means that within the tech sector there aren't many names that are appealing to us.

**Q: Would you explain your valuation models in more detail?**

**A:** I'll start with the PEGY ratio, which is a little different from the well-known PEG ratio. We're value investors and yield is important, so we're looking at the P/E on normalized earnings divided by our projection of long-term earnings per share growth plus yield.

Another methodology we use is implied growth rate analysis. We calculate the EPS growth rate that is implied by the P/E and yield of the stock relative to the overall market. We compare that implied growth rate with our long-term EPS growth rate. If our growth rate is higher, then the stock is considered attractive.



Another methodology is a theoretical P/E ratio. We run a regression on the P/E ratios for our universe of stocks against three variables. One is our estimated long-term growth rate; the second is the dividend payout ratio; and the third is our assessment of risk. We get a regression equation which says the P/E is some coefficient times the growth rate plus some coefficient times the payout ratio plus some coefficient times our risk measure. We plug the numbers in for each individual stock and solve for the P/E ratio. Then we compare that to the actual P/E.

The next approach is something that we call 'normalized return analysis,' and this is the simplest and the most subjective of our approaches. The first step is to estimate normalized earnings, which is an input to all of our valuation models. The second step is to determine an appropriate relative P/E ratio for the

stock and we do that judgmentally based on our expectation of earnings growth and risk, based on where the stock has sold relative to the overall market in the past, and after making a judgment about whether or not that can persist. We multiply this relative P/E ratio times the P/E ratio for the overall market to get a target P/E. We then multiply this target P/E ratio times the normalized earnings. The result is a price target.

Our final tool is free cash flow yield. This isn't so much a valuation model as it is simply a calculation. There are times when this works extremely well for us. For example, we were very attracted to the high free cash flow yield of SunGuard Data Systems. Shortly after we bought the stock, it was purchased by a consortium of private equity firms who were attracted by the same thing. We have a little bit different way of defining free cash flow yield. We take a three-year average of capital expenditures and a three-year average of the increase in working capital to smooth out the peaks and valleys.

**Q: Do you view the dividend paying companies more positively than the others?**

**A:** An above average yield is frequently a characteristic of a value stock and can be a function of a low price and/or a high payout ratio. Sometimes a higher payout ratio is a way of management's endorsing the quality of its earnings. When the payout ratio is low, that's often because the quality of the earnings is low or because there's not a lot of truly free cash flow. So, generally, higher payout ratios are positive. And just as having a high level of debt imposes a discipline on management to make good decisions about capital investments, a high payout ratio does the same thing. There have been some studies that show that, actually, higher payout ratio companies have grown faster than lower payout ratio companies. So we are positively disposed towards yield.

**Q: Do you just look for yields or for rising yields? Is dividend growth critical?**

**A:** The dividend growth story is not our strategy. Actually, Fifth Third Asset Management does have a dividend growth strategy, but that's not the strategy of the large-cap value fund.

**Q: What are the key elements of your portfolio construction process?**

**A:** We have between 40 and 60 stocks with no more than 5% in a single stock. We have a minimum sector weight of one-third of the sector weight of the Russell 1000 Value so that we'll always be in each of the ten major economic sectors. We have a maximum sector weight, which is the lesser of two things: 1) three times the weight of the sector in Russell 1000 Value; and 2) the Russell 1000 Value sector weight plus 10%. The second constraint keeps us from being 100% in financial stocks, which are currently in the mid 30's as a percentage of the benchmark.

**Q: How do you decide on the size of the position or the sector weights?**

**A:** It's much more bottom-up than top-down. If we find a lot of attractive stocks in a particular sector, then we'll have an overweight in the sector, and the more attractive the stock is, the bigger the weight will be.

We occasionally have some conviction about a top-down issue. For example, we may have a high degree of confidence that the economy is going to continue to expand and so we would emphasize cyclical sectors.

**Q: What kinds of risk do you perceive and how do you mitigate them?**

**A:** Aside from the position limit of 5% in a single stock and the constraints on our sector bets, we also get a lot of statistical information about our portfolio relative to our benchmark, such as beta, tracking error and risk index exposures. We want to be different enough from our benchmark so that we're not

a quasi-index fund, but we don't want to be so different that we're not actually delivering the performance of large-cap value stocks. We don't want to be drift-


ing off into growth space or down into mid-cap space.

In each of our valuation approaches, we have a quantitative way of determining relative stock risk. We run a report that includes measures of financial strength, including interest coverage and balance sheet ratios, stability of earnings, volatility of the stock price, variability of earnings estimates, and liquidity. We rank all the stocks that we follow on that basis and then divide them into quintiles, with quintile one being highest quality and quintile five being lowest quality.

So, for example, with the PEGY ratio and implied growth rate analysis, we are comparing the results with the other stocks having the same risk quintile. That's our way of risk adjusting and recognizing that for two stocks with the same projected growth rate and yield, the higher quality one deserves a higher PEGY ratio.

**Q: How do you see the challenges for the large-cap value manager in the current environment and for the next two or three years?**

**A:** We're seeing increasingly better values in larger-cap stocks and, recently, even in mega-cap stocks. I believe large cap value stocks will outperform smaller cap value stocks in the next several years.

In terms of whether value will do better than growth, value has outperformed growth for the last six calendar years and is ahead year-to-date. And over longer periods of time value has outperformed and I believe that will be the case over long time periods going forward. But value stocks are now fairly expensive relative to growth stocks in terms of P/E's, price/book, etc. So near term, it's likely that growth will be more competitive. 

**Ticker**

**“Value stocks, characterized by low P/E's, low price-to-book ratios and high yields have outperformed growth stocks historically. That is because investors, in valuing stocks, underestimate the tendency for earnings per share growth rates and profitability to mean revert.”**



**JIM KIRK** is Managing Director of Value Strategies for Fifth Third Asset Management. Jim previously served as Director, Large Cap Value Strategies since he joined Fifth Third in 2002 and has accumulated 34 years of investment experience in the capacities of portfolio manager, director of research, and investment officer.

Prior to joining Fifth Third, he spent almost three years as the chief investment strategist and manager of a value equity fund for National City Investment Management Co., and then four years as the chief investment officer for National City Bank's Private Investment Advisors Group. Prior to his association with National City, Mr. Kirk was the President and Chief Investment Officer of Society Asset Management, a subsidiary of KeyCorp. Jim graduated from Case Western Reserve University with an M.B.A. in addition to a B. A. in Economics.