

Micro Cap with Macro Returns

The Brazos Micro Cap Fund digs into the micro-cap arena looking for companies with potential for rapid growth in earnings and revenue under reliable management. The key to this strategy is spotting opportunities before the market does and, hopefully, enjoying the ride from market cap in the range of \$100 to \$600 million to \$1 billion.

Q: What's the investment philosophy of the fund?

A: I'm always looking for earnings and earnings growth, so we are definitely growth investors. We tend to focus on non-GAAP earnings or free cash flow and we don't like using discounted cash flow. We try to identify earnings growth in companies before the rest of the market does by buying in the most inefficient part of the market, which is the micro cap arena. Stocks that come into the portfolio are generally \$600 million in market cap or under, and we sell them when they get to over \$1 billion.

Q: Is earnings growth the only criterion for finding undiscovered micro-cap companies or are there other factors as well?

A: We certainly look at the growth in revenues and we like to find companies with operating margins that are expanding so earnings grow faster than revenues. It's not so much what the companies have done historically, but it's forward-looking in terms of what they can do in the immediate future. If a company has just become earnings positive but the possible future earnings makes the multiple attractive, then we'd be interested. We like companies with acceleration in their earnings growth.

Before we get involved in a stock, we discuss with management what their strategy

and expectations for the growth are and what the operating model should eventually look like.

Q: How many companies are there currently in your universe of between \$100 million and \$600 million micro cap?

A: We focus on companies in our benchmark, Russell 2000 Growth, but we often look at companies that are even too small for that index. There are a lot of companies to sift your way through to find some pearls. We do have a few that are under \$100 million in cap but we make sure we have enough liquidity. We don't like to hold more than 10 days of trading volume in anything so we can make sure that we can get out if we make a mistake.

Q: How would you describe your investment process?

A: First, we have five portfolio managers and each of us covers one or two sectors. We're familiar with the names and the sectors we cover. We also use screens to identify companies that have either a positive move in their earning growth, or have been beating Wall Street estimates for a while, or companies that we think are going to have acceleration in their earnings growth going forward. Then we'll start doing more fundamental work and we also look at some technicals. If there's a company that has been doing well in the market

Fund Facts

Symbol	BJMIX
Website	www.brazosfund.com
Address	Brazos Capital Management, Inc. 5949 Sherry Lane, Suite 1600 Dallas, TX 75225
Tel. No.	800-426-9157
Inception	12/31/1997

Portfolio

Total Net Assets *	\$84.4
Avg Mkt Cap (\$ Weighted) *	\$408
Average Price/Earnings Ratio	22x
Average Price/Book Ratio	3.3
Turnover Ratio	197%

Investment Information

New Investment	Open
Min Initial Investment	\$2,500
Min Subsequent Investment	\$100
Min Initial IRA Investment	\$1,000

Risk (Against Russell 2000 Growth- 3 Years)

Alpha	-0.13
Beta	1.10
R-Squared	0.86
Ann Std Deviation	19.29
Sharpe Ratio	0.75

Returns vs. Russell 2000 Growth Index

	BJMIX	Index
1 Year (Cum.)	2.29%	14.58%
3 Year (Ann.)	10.02%	16.27%
5 Year (Ann.)	1.86%	3.49%

Returns vs. S&P 500

	BJMIX	Index
1 Year (Cum.)	2.29%	8.63%
3 Year (Ann.)	10.02%	11.22%
5 Year (Ann.)	1.86%	2.49%

Fees and Expenses

Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee	0.00%
Total Expense Ratio	1.52%

Portfolio Manager

Team Managed	Aug-2004
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* millions

Source: Company Documents; Lipper

Data through: 6/30/06



relative to its peers, we'll take a look at that.

Each of the five portfolio managers covers a few different sectors. I cover technology and consumer, but in terms of day-to-day management of the product, I'm the lead portfolio manager on our micro-cap and our small-cap fund. We also have a mid-cap fund and a growth fund, managed by Michael Allocco.

Q: *Are these five people looking at various sectors only in the micro-cap arena?*

A: We all monitor stocks along several different cap ranges. The lead manager on our mid-cap product also covers semiconductors, so he may find a micro cap semi name that he wants to put in the portfolio. Our process is all team-driven. We meet three times a week to talk about the macro economic conditions, or about industry trends as well as about new names.

We look at earnings growth and valuation in several different ways - relative to the market, relative to the company's peers, and relative to the growth rate. We want to make sure that we get the valuation and the earnings growth potential right. Also, we love companies that have solid, seasoned management teams.

Q: *Can you give us some examples of historic stock picks? What process led you to select those stocks and what happened to them in your portfolio?*

A: True Religion was a name we owned. We got involved there in the middle of 2005. They were a premium denim company and had experienced a strong demand for their product. Typically, they sold to boutique stores, but they were starting to get more into department stores as Nordstrom's and Neiman's. We loved the earnings potential and the company continued to beat their own internal estimates and the estimates of Wall Street. It had excellent earnings growth and the valuation was very reasonable.

When we bought the company they had 22 million shares at \$12, so their market cap was about \$245 million. We had price target of \$20. They did exactly what they said they were going to do - they got into Neiman's and Nordstrom's, came out with new products outside of denim, and the stock continued to do well. We trimmed just under \$20, then it

got up to \$24 and we let our entire position go. Street estimates were very aggressive in terms of growth they would need to see in 2006 against some very tough comparables in 2005 and since it had reached our target price, we sold the stock. Now they are up against some tough comparison from last year in terms of denim sales, so their growth is decelerating. The stock is below where we sold it so it was a good sale.



Another example is Stellent, a content management company. They have software products that used to manage unstructured data especially in environments with multiple sites and ones that have a lot of compliance policies. Sarbanes Oxley is actually a big driver for their business. The industry analysts like Gartner and Forrester have been champions of their products and started recommending it for all their clients so the license growth has been very strong, leading to high-margin revenue. Their revenue growth accelerated and their earnings grew much faster than the revenue. They finished their fiscal 2006 in March with a 7% operating margin and made 35 cents per share. Operating margins should continue to expand to 14% in fiscal 2007 which would equate to about 60 cents in earnings. The long-term operating margin target of 18% to 20% would give the company fully taxed earnings potential of a little more than 70 cents. We started buying this stock last year around \$8 and it got as high as \$13 earlier this year. Now it's at about \$11.50 but we think it is worth around \$14.

The old CEO and founder retired several years ago, and when they brought a new CEO in the company struggled. Then the original founder came back and got the company on the right foot. I think this

company would probably be a great take-over candidate. This part of software has been consolidating rapidly and as Oracle and SAP have been buying software to improve their growth, I think this would make a great acquisition candidate.

Q: *Are the managers of these micro-cap companies easier to talk to?*

A: Definitely. They don't get the attention that large-cap companies do. They want their stock to do well because they are typically large holders and they like to see that people are interested in their company. Being excited about your business and aggressively communicating to investor community, often can be a good catalyst as well. Since we have some other larger-cap products, ultimately we'd love to find companies that we can own as a micro-cap to keep getting bigger, and we'd own them in small-cap and then into our mid-cap funds.

Q: *In your experience, have many companies gone through that cycle in the last few years?*

A: Yes. It all depends on the business model, how sustainable it is versus more cyclical type of businesses and ones that do an acquisition here and there to get themselves bigger.

An example I can think of is WebSense. We owned it when they came public in 2000. A lot of their revenues are done or pre-sold and they collect the cash over several years or they have long-term contracts. They sell 1 to 3-year licenses out to people and they recognize revenue each month it comes in. We don't own the stock now, but we owned it when it was a micro-cap company when it came public and it gradually grew to becoming a \$1.1 billion market cap company.

Every quarter I have names that get over \$1 billion and I have to let them go but our small-cap fund can continue to hold them. We're always looking for new ideas and continually have names in the pipeline that either have a lower weighting or we're waiting for the right price or for a certain catalyst to get it into the portfolio.

Q: *How do you start with the idea creation that becomes a stock in your portfolio?*

A: Occasionally, we do come up with investment themes. We had one in 2004 when we noticed a lot of stocks doing well in industries that, on the surface, were not related. We did more work on this and it all came back to homeland security and defense. Many names popped out from there and we went back and talked to the companies. A lot of the money we hoped to see after 9/11 started freeing up and a lot of people were experiencing accelerated growth rates in their revenue. Once we find a theme like that, we may put 15% to 20% of the portfolio if we can find good companies. We did that back in '04 and it helped our performance.

We're now seeing increases in the non-residential construction theme, for example. We've had a lot more industrial names that have helped out the portfolio this year. One industrial name that we own is Flow International. They make water jet cutting tools that are used a lot in carbon composites that are being used by the new jets made by Airbus and Boeing. This company has come out with this water-jet cutting tool that is being widely used by the Aerospace industry, and it's making it into new markets. For example, SanDisk has ordered some of their products -- it's a \$600,000 product at better than average margins.

We've got a lot of companies like that, including Badger Meter or heating ventilation companies like Comfort Systems.

Q: *Would you explain your portfolio construction? How many names do you have, what is the turnover, and what benchmark do you use?*

A: We usually carry about 50 to 55 names. We put a lot of focus on our top 20 names, which tend to be about 45% to 50% of the portfolio. Turnover is typically around 200% in dollar terms. The name turnover is much lower, closer maybe to 100%. We benchmark ourselves to the Russell 2000 Growth index. Occasionally we'll look at the smaller end of the Russell 2000 Growth and that's more representative of our market cap range. ■

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about

Jamie Cuellar, CFA

Jamie Cuellar is a native of Dallas, Texas. He graduated from The University of San Diego where he received a B.B.A. with emphasis in finance. After returning to Dallas and working for Fidelity Investments, Jamie earned his M.B.A. from Southern Methodist University in 1995 and his Chartered Financial Analyst designation in 1996.

After business school, Jamie worked as an investment analyst for Lee Financial Corporation, a financial planning and investment management company catering to high net worth individuals. As a member of their investment strategy committee, Jamie was responsible for determining asset allocation and selecting money managers for Lee Financial's investment partnerships and client portfolios. Having been a client of the Firm for five years, Jamie joined Brazos Capital Management in February of 2000.

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