

Only the Best Ideas

Security Select 25 is a concentrated growth fund, but it isn't interested in just any type of growth. Valuation is a crucial part of its philosophy as well as the competitive advantage of the underlying companies and their ability to improve pre-tax returns on invested capital. With a longer time horizon, the fund invests only in its best ideas and gives them enough time to produce results

Q: What's your investment philosophy?

A: There are three things we consider very important: valuation, long-term time horizon, and concentrating a portfolio. Our firm uses the same philosophy and applies it to different universes. For this fund, we use a growth universe.

First, we believe valuation is critical to our investment decision. We look for ideas with a margin of safety. For a growth oriented fund, we do not want to write a blank check for growth. Second, we think about investment opportunities over the long-term. We are seeking companies that can sustain or improve over a three to five year time horizon. This requires patience. Third, we develop a concentrated portfolio and are willing to take sizeable positions if the opportunities warrant. For Security Select 25 fund, generally we own 20-30 names. As we perceive we own businesses rather than stocks, we have a fairly low idea turnover rate.

We define growth ideas differently than the market. We are looking for companies that generate a pre-tax return on invested capital (ROIC) greater than the market median. The market's median ROIC is just under 14% today, and any company that's able to generate higher than the market pre-tax ROIC is considered a potential growth idea.

Occasionally we will own companies in the growth portfolio that have less than the market's pre-tax ROIC. For these we must believe they are capable of improving their returns above the market's median ROIC within our three to five year time horizon. Federal Express is an example. We bought it in 2004 in the high \$60s when they were generating less than 7% in pre-tax ROIC. Today the stock price is over \$110 and its pre-tax ROIC is greater than 11%. The Kinko's acquisition, although it lowered the pre-tax ROIC in the short-term, allowed them to reposition the business and get margin improvements long-term. Even

FUND FACTS

| | |
|-----------|--|
| Symbol | SEFAX |
| Website | www.securitybenefit.com |
| Address | Security Management Company, LLC One Security Benefit Place Topeka, KS 66636 |
| Tel. No. | 1-800-888-2461 |
| Inception | 1/29/1999 |

PORTFOLIO

| | |
|------------------------------|----------|
| Total Net Assets * | \$64 |
| Avg Mkt Cap (\$ Weighted) * | \$45,802 |
| Average Price/Earnings Ratio | 21.3 |
| Average Price/Book Ratio | 3.1 |
| Turnover Ratio | 20.58% |

INVESTMENT INFORMATION

| | |
|----------------------------|-------|
| New Investment | Open |
| Min Initial Investment | \$100 |
| Min Subsequent Investment | \$100 |
| Min Initial IRA Investment | \$100 |

RISK (AGAINST S&P 500 - 3 YEARS)

| | |
|-------------------|-------|
| Alpha | -1.42 |
| Beta | 1.16 |
| R-Squared | 0.72 |
| Ann Std Deviation | 10.66 |
| Sharpe Ratio | 0.78 |

RETURNS VS. RUSSELL 1000 VALUE INDEX

| | SEFAX | Index |
|---------------|--------|--------|
| 1 Year (Cum.) | 14.75% | 6.12% |
| 3 Year (Ann.) | 10.87% | 8.35% |
| 5 Year (Ann.) | 0.99% | -0.76% |

RETURNS VS. S&P 500

| | SEFAX | Index |
|---------------|--------|--------|
| 1 Year (Cum.) | 14.75% | 8.63% |
| 3 Year (Ann.) | 10.87% | 11.22% |
| 5 Year (Ann.) | 0.99% | 2.49% |

FEES AND EXPENSES

| | |
|-----------------------------|-------|
| Max Sales Charge - Front | 5.75% |
| Max Sales Charge - Deferred | 0.00% |
| Max Redemption Fee | 0.00% |
| Total Expense Ratio | 1.67% |

PORTFOLIO MANAGER

| | |
|------------------|---------|
| Mark A. Mitchell | 2/27/04 |
|------------------|---------|

* millions

Data through: 6/30/2006

Source: Company Documents; Lipper



though it's not as compelling as it was in early 2004, we still believe they can improve their results above the median market rate.

Q: How do you estimate future growth? Do you consider historic growth to come up with the estimates?

A: That's the challenge in the growth universe. It is important to be aware not only of where the historical pre-tax ROICs were, but also a company's reinvestment opportunities. For example large-cap pharmaceutical companies appear to be generating ROICs in excess of the market. The question is what are their reinvestment opportunities? Many pharmaceutical companies may be generating 25% pre-tax ROIC, well in excess of its cost of capital, but have limited reinvestment opportunities. Other growth investment approaches reward a company that can grow fast. Companies who either are putting capital to work at lower than current pre-tax ROIC levels or growing without regard to their cost of capital employed on this expansion will eventually be figured out by the market. As they generate lower levels of pre-tax ROIC, valuation levels typically drop to reflect this over time.

Managing both value and growth portfolios, we find the difference between them is that it's difficult to find a large margin of safety for growth ideas. This can cause volatility in fund performance. An example would be Zimmer Holdings. It is a company with a pre-tax ROIC in excess of the market but when something goes wrong, such as it falls short of quarterly earnings forecasts, the stock responds with a sharp sell-off because of the absolute p/e multiple it carries. This is what makes growth investing more difficult.

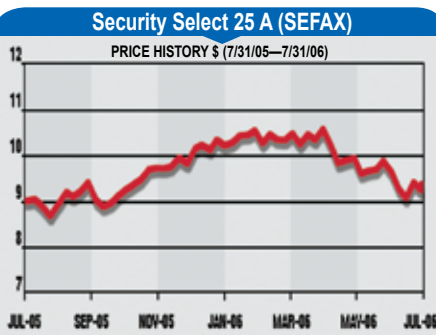
Another example we own is ADC Telecom, which fell about 25% in two days. While it didn't have a high P/E multiple, we believed the firm was capable of earning a pre-tax ROIC greater than the market. Recently ADC Tele-

com had not been generating a pre-tax ROIC in excess of its cost of capital and we believed they had a vision and resources to get there. All of a sudden, the management decided to acquire a company with lower returns and slower growth prospects. The market reaction was swift and stock lost 25% of its value.

Because we do not employ an earnings or price momentum approach, we tend to under perform a growth peer group when momentum approaches work. When valuation matters, we tend to outperform other growth strategies.

Q: How would you regard BlackBerry-maker Research in Motion and flash memory-maker SanDisk?

A: We really struggle with names like these. We are good at recognizing what we know and what we do not know. I



am not able to guess what Research in Motion will look like in three years even though they have been able to grow significantly in the past. We have trouble focusing on hyper-growth companies. We prefer to focus on quality companies that generate or will generate pre-tax ROICs greater than the market median and have good reinvestment opportunities.

We usually buy when there is something weighing on the stock in the short term. We buy when the discount is caused by what we view as a transitory event, not a terminal problem. If the company is able to fix the situation or the perception changes, we're going to make money.

Q: Would you describe your investment process?

A: We have a long list of companies that we watch and know. We review this list every day and hope that transitory events happen. Unfortunately, these types of opportunities are not always bountiful, so we continue to search for them and remain patient.

Our process employs a bottom-up, fundamental stock-picking approach. We focus on finding the best 20 to 30 opportunities in which to invest. We do not spend much time thinking about the economy and sectors. Names stay in the portfolio unless a significantly better opportunity appears or we believe the company's ability to impact pre-tax ROIC has been impaired.

Our analyst team focuses on evaluating a company's competitive advantage including analyzing management, resources and industry opportunities. For growth companies, we need to believe a company has a sustainable competitive advantage. For value ideas, you may get opportunities with something just being cheap enough, but that's not the case on the growth side.

We try to understand management's vision and strategy for running the business. Do they have a history of creating shareholder value? We also examine the resources used to sustain and/or grow the business, including both financial and human resources, and finally the growth potential and competitive situation in their industry.

Q: Do you follow investment themes when selecting those 25 names?

A: No, we don't. We screen the universe, go through the list, and some names always show up. We don't start with a theme but we'll often find a company that may lead us to other investment ideas.

Carnival Cruise Line is a name that's been in the fund for some time. The cruise industry historically had been adding 10% to 15% annual capacity in

terms of rooms or berths, and has cut back to 5% to 8% capacity growth. We know that more people are taking cruises. People are getting older and it is a fun thing to do. It takes three years to put a ship on line so the industry growth looks interesting. Therefore, you've got an increasing penetration, whether it is driven by demographics or not, combined with an industry that is now unable to add the same amount of capacity as before. Carnival acquired Princess Cruises, increasing its circle of competence, to target more consumer segments. With the Princess acquisition complete, Carnival is working on becoming more efficient. Given this scenario, we believe they will be able to generate higher pre-tax ROICs going forward. Carnival's stock price has fallen back a bit this year due to concerns over the consumer slowdown, but we still see a sizable opportunity here.

We add value with our ability to evaluate if a situation makes sense going forward. Our team completes fundamental research, talking to the companies, going through the financials, putting the numbers through different models to see if their vision and strategy makes sense. We try to identify upside and downside price targets thinking from a probabilistic standpoint. We make sure we truly understand the positive and negative side of the story and try to figure out the likelihood of these events happening.

Q: How is your research organization structured?

A: We have a team of eight investment professionals, including myself. Five of us focus on sectors in the large cap universe and three on the mid-cap universe. Therefore, we have eight professionals evaluating businesses all day long.

We employ experienced, talented professionals who have a passion for investment analysis and their sector. We have a consumer analyst with 19 years of experience in the area. Occasionally we are willing to train talented people too. Our financial analyst was instru-

mental in finding First Marblehead, a student lender with a unique database with historical perspective on student loan underwriting, when the name was completely under followed.

Ninety percent of our research effort is internal and ten percent comes from the Street. We spend a lot of time looking at 10-Ks and 10-Qs and talking to companies. We use Wall Street mainly to fill in the gaps or to understand the street's bull or bear case.

“I believe that the Street is so incredibly near-term focused that our advantage is being able to stay above that noise and think and invest over the longer term.”



MARK MITCHELL joined Security Management Company, LLC in 2002. He manages the firm's Large Cap Value, Large Cap Growth and Large Cap Blend strategies. Previously, Mr. Mitchell was a portfolio manager and analyst with GE Asset Management from 1994-02. He earned a Bachelor of Science degree in finance from the University of Nebraska. Mr. Mitchell has earned the right to use the Chartered Financial Analyst designation.

Q: How do you approach constructing the portfolio of 20 to 30 names? What's the turnover of the fund?

A: We usually try to have at least 25 names in the fund, and we do not have a target turnover. The Street is so incredibly near-term focused that our advantage is being able to stay above that noise and think and invest over the longer term. This makes you ask different questions, not about the catalyst to the next quarter's earnings report, but about the picture in five years. This way of thinking permeates everything that we do.

Initial positions in the portfolio range from 3% to 5%. We have a maximum position size of 10%. When it gets closer to 8%, we typically tend to trim it back for risk control purposes.

Q: Despite the return of the major averages to pre-2001 levels, large caps like Citigroup or Home Depot have not delivered during the last four years. Do you worry that you may have to deal with investors' lack of enthusiasm because sometimes you may not be able to hold something for five years?

A: Yes, growth investing has been very challenging. We try to communicate clearly with investors about what they can expect investing in each strategy. Our goal is to out perform our Russell 1000 Growth index, the benchmark, over the market cycle. If momentum strategies are working, we'll certainly lag in those markets. However, we believe it is better to explain to investors how we think, what we do, where we'll perform well, and where we may not perform as well. **T**

Ticker