Trust in Positive Surprises

Diversified Mid-Cap Growth Fund normally invests at least 80% of its net assets in securities of medium sized companies. Portfolio manager Clifford Fox seeks to generate better returns by identifying companies with positive earnings momentum before the market. The manager believes in the power of positive momentum and positive surprise.

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

A: Our philosophy is that companies that exceed investor's expectations tend to be rewarded with higher stock prices while those that disappoint tend to be punished with lower stock prices. We call the philosophy 'Positive Momentum and Positive Surprise'. Positive momentum is growth in a company's business, ideally accelerating, and positive surprise is the leading indicators of a company's business being better than expected, either because the environment is strengthening or their execution is improving and ideally some of both.

Q: ***Could you describe your research process in more detail?***

A: We're focused on the leading indicators of the business. Most people don't have any trouble believing that if you can find companies whose businesses are better than expected, you should ultimately be able to outperform the market if you can identify them in a timely manner and can do it in a repetitive fashion. That's where the structure of the implementation of this philosophy comes into play.

We use a four-step process. The first thing we do is try to understand what those leading indicators are that drive the company's business. Some of those are in the environment so they can include economic factors, secular trends, industry dynamics, supply and demand or competitive structure of the industry.

In the second step, we need to understand what the expectations are out there. We talk to a variety of the sources of information to help gauge those expectations. We'll talk to the companies, competitors, suppliers, and customers. The Wall Street analysts are important because they create earnings models and communicate that to other investors. There's business press, trade press, economists who provide information and forecasts. From this variety of sources you can get a good idea of where the stakes are in the ground that are holding this stock in place and underpinning its current price in the market.

The third step is where we gather additional information that gives insight into how the key factors are developing and whether they're likely to be diverging in a favorable or unfavorable direction. What we're looking for are those companies that have a significant majority of what drives their business diverging to the upside, making it likely that for the current quarter and for the foreseeable future, the company is growing faster or be-

Diversified Inv Mid-Cap Growth

Fund Facts

Symbol	DVMGX
Website	www.divinvest.com
Address	Diversified Investment Advisors, Inc. Four Manhattanville Road Purchase, NY 10577
Tel. No.	800-755-5801
Inception	5/15/2001

Portfolio

Total Net Assets *	$ 137.9
Avg Mkt Cap ($ Weighted) *	$ 5,000
Average Price/Earnings Ratio	36.7
Average Price/Book Ratio	N/A
Turnover Ratio	142 %

Investment Information

New Investment	Open
Min Initial Investment	$ 5,000
Min Subsequent Investment	N/A
Min Initial IRA Investment	N/A

Risk (Against S&P 500 - 3 Years)

Alpha	-0.37
Beta	1.47
R-Squared	0.65
Ann Std Deviation	13.74
Sharpe Ratio	0.66

Returns vs. Russell Mid-Cap Growth Index

	DVMGX	Index
1 Year (Cum.)	11.47 %	2.98 %
3 Year (Ann.)	13.81 %	14.10 %
5 Year (Ann.)	1.23 %	5.46 %

Returns vs. S&P 500

	DVMGX	Index
1 Year (Cum.)	11.47 %	5.38 %
3 Year (Ann.)	13.81 %	10.80 %
5 Year (Ann.)	1.23 %	2.82 %

Fees and Expenses

Max Sales Charge - Front	0.00 %
Max Sales Charge - Deferred	0.00 %
Max Redemption Fee	0.25 %
Total Expense Ratio	1.34 %

Portfolio Manager

Clifford Fox	5/01/2006

* *millions*

Data through: 7/31/06

Source: Company Documents; Lipper

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coming more profitable and turning into a more valuable investment than anticipated. That makes it a candidate for us to put into the portfolio.

The fourth step is to construct a diversified portfolio using positive momentum and positive surprise.

Those companies that look like they're going to disappoint people are the stocks we want to avoid or if we happen to own them, and it looks as if things are evolving in a negative fashion, we want to exit them as gracefully as possible.

The companies that are essentially in line with expectations may in fact turn out to be good investments for someone else, but they don't fit our discipline because we just don't know whether the next piece of information is going to diverge favorably or unfavorably.

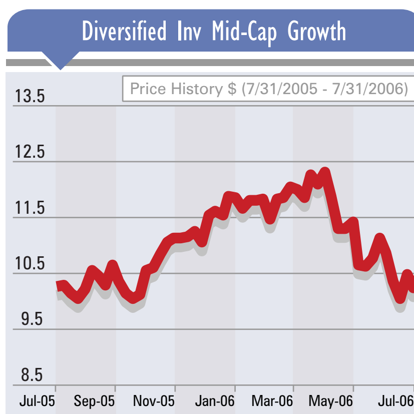
Q: ***What are the key elements of your portfolio construction?***

A: We build our portfolios in a diversified fashion across a number of groups of companies that have common positive surprise elements, which we call themes. For example, you might find several companies that are component suppliers into a wireless company. If you are seeing upside divergence in terms of demand for a key product in the wireless company's product line, those suppliers are likely to be seeing upside to demand for their components as well. Since there is a common key driver that's pulling all their businesses along, we would group them together as a single theme because we would know that new information would tend to impact them all either favorably or unfavorably if it diverged from expectations.

In mid-cap we typically have about 45 - 55 stocks in a portfolio. That number will vary with the number of attractive names that we're finding and the current confidence level in the environment. We're not market-timers, so cash is usually less than 5% of the assets. If you think about a 50-stock portfolio, we're typically going to have about a 2% average position. We're going to start with about 1% weighing - anything less doesn't have much of an impact on the portfolio. As long as we're continuing to get an information flow that reinforces the story, we'll tend to move within a few weeks to the 2% level, as a fully represented stock in the portfolio. We do have the ability to have positions as high as 5% of the portfolio at market value, but it's relatively infrequent that individual holdings exceed 4%.

Q: ***How would you define your sell discipline?***

A: The sell discipline is very symmetrical to the buy discipline. We try to identify change early and determine companies whose businesses are beginning to do better than expected in order to get on board those stocks. We will stay with them as long as their fundamentals impress investors and as long as the leading indicators appear to be staying better than expected. We're looking to reduce exposures and to exit stocks as the gap between expectations and reality begins to close.



We're not a value oriented player, so when a company's fundamentals begin to deteriorate there isn't a price at which we'll say we are not happy with the business but it's too cheap to sell. Similarly, on the other end of the spectrum, while we don't like buying expensive stocks, we won't say a stock is too expensive. If the fundamentals are much better than the investors expect, they will likely drive the stock higher over time.

Q: ***How is your research organized and how many people do you have on your team?***

A: We have eight people on the team, managing both our Mid Cap and our Small Cap funds. They follow stocks in a market cap spectrum from about $100 million to $15 billion with some overlap in the middle between the two funds. The analysts follow industries across several sectors in order to give them exposure to different parts of the economy. We never want somebody who just does tech or consumer discretionary, because the last thing we want when a particular area is out of favor, because of weak business conditions, is an analyst trying to pick the best stock out of a bad group. We think it is much better having somebody who does part of healthcare, part of consumer, part of technology.

Our analysts do not create their own earnings models. Instead, they try to understand the collective Wall Street earnings model and understand the drivers of that earnings model. Then they gauge whether or not the inputs to that model are getting better, worse, or are just in line with expectations. Our view is that regardless of the valuation metric other investors use - Dividend Discount Model, P/E to growth rate, etc - as long as the company's business is getting better, the stock will look increasingly attractive.

We have a common morning meeting with our large cap group before the market opens in New York to cover information that's likely to be of interest to everyone. Then we break down into our smaller groups to discuss individual stocks and decide on trades.

Q: ***Can you describe some stocks that you picked?***

A: Lamar, the billboard company, is a mature business with some economic sensitivity depending on advertising trends, but there is an interesting secular change going on there - the move to digital billboards. It's very early, in the sense that they're targeting a couple hundred by year-end out of 80,000 billboards, but the dynamism in terms of revenue per billboard is impressive - in the range of 5 to 9 times what they previously could get.

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One of our small cap companies is Daktronics, which makes digital sports displays and billboards. In the most recent quarter, in round terms, they produced revenues of about $90 million compared to $80 million expected. This suggests that the demand for digital billboards is rising faster than expected.

Although Lamar had expected to install about 1,000 digital billboards by 2010, they commented recently that the limiting factors were municipal regulations and sustaining high revenues per billboard. And they indicated that regulatory pushback had lessened over the last year, making them more optimistic about the rate at which they could install digital billboards.

That sounds encouraging for both Daktronics and Lamar and shows the benefit of using information from multiple sources to cross check business conditions.

Q: *What kind of risk do you perceive, measure and control?*

A: We tend to think of risk control from a fairly traditional diversification perspective. We're not big on some of the quantitative models other people use, and the reason is that when you're building a portfolio of companies that have positive surprise in their fundamentals, often the backward looking statistical characteristics of how they have traded becomes much less relevant. This is because the improving business fundamentals are attracting new investors, causing the stock to respond to key fundamental developments rather than just floating along with the market or trading with its group.

We do diversify. If you look at it from a sector perspective, the biggest weighting will be 25%, or in the case of the very few largest sectors which, in growth, tends to be technology, consumer discretionary, and healthcare, we give ourselves leeway to be ten percentage points higher than the index weighting. So if an index weight were 20% in a sector, we could be 30%.

Q: *Do you follow any benchmarks, like a mid-cap index?*

A: Most of our clients benchmark us to the Russell Mid-Cap Growth Index. We have a few that will look at us against a style neutral index over the course of a cycle, but that's over a many-year period.

For the mid cap fund, we look at stocks in the range of $1 billion to $10 billion market cap for initial purchases, but we also often happen to think of there being about 800 stocks in our investment universe.

Q: *Can you give us a few examples in which your research process helped you identify stocks and some examples of stock picks that did not work?*

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about **Clifford Fox**

CLIFFORD G. FOX, CFA

Senior Managing Director/Portfolio Manager Mr. Fox joined Columbus Circle Investors in October, 1992. Prior to this, he was Vice President of Equity Investments at General Reinsurance Corporation. He received his M.B.A. from the Stern School of Business, New York University and his B.S. from the Wharton School, University of Pennsylvania. Mr. Fox earned the right to use the Chartered Financial Analyst designation and he is a member of the New York Society of Security Analysts.

A: In May of 2003 we bought Harman International, a company known for high-end car radios. When we looked at it at that point in time, the real key element of our decision to buy was that people perceived the company to be selling a commodity product, meaning car radios, to a tough group of buyers, meaning car companies. The reality was that car companies were beginning to move from buying discrete components like radios, telephones, DVD players and GPS to integrated networks. Harman was beginning to win significant amounts of business and instead of selling $300 radios they were selling $1,500 - $2,000 systems - higher price point, higher revenues, and better profit margin potential. The car companies did this because they were able to cut out meaningful amounts of weight and cut out meaningful amounts of cost compared to buying all the individual components. We sold the stock about a year ago after its having been a very good performer. What changed in terms of the expectations versus reality was instead of winning almost every competition and remaining the dominant player, they started to lose little bits of competitive share.

A recent disappointment was Janus, which we purchased last fall. It worked well for a while and we did make some money. When we bought it, asset flows were improving because their key investment product was growing rapidly and they had improved performance on some of their mutual funds, allowing outflows to begin to dissipate. They were also talking about significant cost cuts that suggested the ability of leverage the new business. That should have worked out, except they reversed themselves on the cost cutting and started spending a lot more money than they had planned to spend. We decided to exit the stock as management's spending plans turned a positive into a negative and seemed likely to limit the company's ability to generate upside. ▮

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