

Power of Basics

Many fund managers target stable growth but few base their investing on the most stable human needs existing from the beginning of time. Gerald Sparrow, the manager of the Sparrow Growth Fund, invests in companies that serve necessities such as housing, utilities, food, and certain services. Otherwise, the fund is free to invest in any market cap range and any geographic market as long as the stocks satisfy its growth criteria.

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

A: The basic philosophy is to invest in businesses that serve a basic human need that has existed from the beginning of time and will go on forever. We believe that the strategy of buying companies that satisfy those needs provides a consistent return with low risks and beats the market averages over time.

We buy securities related to things that people need to have or to human nature activities. For example, industries like housing have been around forever because people need to have a shelter. Such as stock is Ryland Group, one of the leading home builders. Also, people need to dress themselves and to have shoes, so we own Nike and Wolverine World Wide.

This is an all-cap strategy fund and we're allowed to buy any market cap in any market, so we can be foreign or domestic and up to 15% bonds.

Q: The notion 'necessity' varies around the world. For example, cable TV may be considered a necessity in the US but not in most other countries. How do you reconcile that?

A: In such cases I would stick to basic requirements. But our definition also includes stocks like Wrigley's and Hershey, for example, because I myself have tried to stop eating chocolate unsuccessfully and we consider that a basic need.

I also invest in insurance stocks because I believe that people's tolerance for risk is important. We are investing up to 22% of the total account in the financial services industry. Our largest holding is First Cash Financial Services, the pawn store broker. They provide basic lending services to a population group that typically is not good with money or doesn't have banking accounts.

In our capitalist system people can trade their time in for cash. You exchange your labor for cash, use that cash, deposit in the bank, pay out your credit cards, buy some goods and services, or save it. So I consider financial services to be a basic requirement of any society that's beyond barter trading. Any civilization with a currency system needs that service.

Q: Do you also invest in healthcare or health insurance stocks?

A: No. We're low in both technology

FUND FACTS

Symbol	SGFFX
Website	www.sparrowfunds.com
Address	Sparrow Growth Fund 11330 Olive Ste 230 Saint Louis, MO 63141
Tel. No.	888-727-3301
Inception	9/4/1998

PORTFOLIO

Total Net Assets *	\$9.5
Avg Mkt Cap (\$ Weighted) *	\$40,500
Average Price/Earnings Ratio	21.25
Average Price/Book Ratio	3.7
Turnover Ratio	50%

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$10,000
Min Subsequent Investment	\$500
Min Initial IRA Investment	\$2,000

RISK (AGAINST S&P 500 - 3 YEARS)

Alpha	0.00
Beta	0.89
R-Squared	0.75
Ann Std Deviation	2.24
Sharpe Ratio	0.82

RETURNS VS. RUSSELL 1000 GROWTH INDEX

	SGFFX	Index
1 Year (Cum.)	9.24%	6.04%
3 Year (Ann.)	9.38%	8.35%
5 Year (Ann.)	6.90%	4.42%

RETURNS VS. S&P 500

	SGFFX	Index
1 Year (Cum.)	9.24%	10.79%
3 Year (Ann.)	9.38%	12.30%
5 Year (Ann.)	6.90%	6.97%

FEES AND EXPENSES

Max Sales Charge - Front	5.75%
Max Sales Charge - Deferred	2.50%
Max Redemption Fee	0.00%
Total Expense Ratio	2.25%

PORTFOLIO MANAGER

Gerald Sparrow	9/4/1998
David Presson	12/1/2003

* millions

Data through: 9/30/2006

Source: Company Documents; CBS Marketwatch



and pharmaceuticals because patents expire, there are a lot of changes going on, and it is too technical for me. In addition, there's a lot of competition in that area and the level of lawsuits is beyond the average. In the hospital industry, the profits are poor, the return on equity and free cash flow yields are low.

Other industries that we invest in include the food, tobacco, and gaming industries. Altria, parent of Philip Morris is one of our largest holdings and we also own Boyd Gaming. We believe that gambling has been around forever and will be here when you and I are gone. Entertainment has always been a part of life.

We also own Makita Corporation because they are a great company. The tools have been around forever, ever since we learned to make a spear. Human beings have always used tools to get something done and that's why I think that tool-making companies will be here forever.

Q: What about the overseas competition from China in that market?

A: We follow the management teams of the companies we own so we watch their execution. Yes, there is international competition. Some of those companies have operations in geographical areas with better price basis per hour for labor so they are able to move their facilities to gain margins. I'm not too worried about Makita because they've got a great track record of competing.

Q: How do you translate this philosophy into an investment strategy and process?

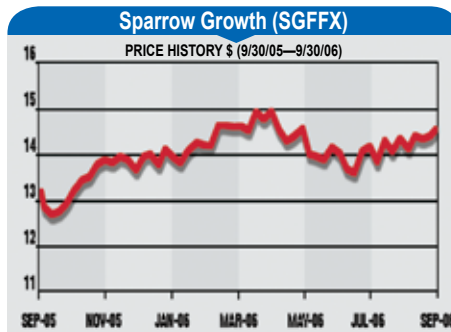
A: We look in various research publications such as Value Line, the Securities Research Company Chart Books, and the industry booklets. We also use Miltex for individual company reports from brokerage firms. We read the 10Ks and the 10Qs to decide if a company meets our criteria for strength of the balance sheet, cash flow, and quality of earnings. We also look at management teams and all the fundamental factors to decide if

the odds are in favor of being successful if we buy the stock for our shareholders.

Once we buy the stock, we follow their business, how they trade throughout the day, and any news that is being released. Every Monday morning we have a formal investment meeting to discuss new and old ideas.

Q: Do you mainly rely on a fundamental approach or you combine it with evaluation of the technical aspects?

A: We use the technical aspects as indicators for buying new positions or adding to old ones. For example, the week before Labor Day has been one of the worst weeks of the year and September is one of the worst months on average for the last 50 years. That's a technical statement so we anticipate a weak week and a weak month and we take advantage of buying opportunities.



We also take the relative strength information and check why a stock is underperforming relative to the benchmark. In other words, we take the fundamental data and compare it to the technical data and use it to buy stock at better prices.

Q: Could you give us a couple of examples of ideas that became part of your portfolio through that process?

A: I would use First Cash Financial Services as an example because it's been one of our best performers. We were looking in the specialty finance area on Investors Business Daily, which ranks the industries by 197 different account

classifications. At the time, the specialty finance companies were rated low on this scale but according to the SRC charts, they had consistent track record of growing sales and earnings. On a relative valuation basis, the stock was cheap.

We investigated their balance sheet, income statement, position in the marketplace, and management team, which had been in place for over 3 to 5 years. We bought the stock and we haven't sold it yet. We've made over 100% in the last four years.

Hershey, the food group and confectionary business would be another good example. They generate a lot of excess cash, raised their dividend, and ranked at the bottom on Investor's Business Daily because the confectionary business was hurt by higher energy prices. The cost of sugar was high and delivering the products became expensive. We looked at the income statement, the balance sheet, the cash flow statement, the management team, and the stock price and we liked what we saw.

Q: Would you give us an example of a stock pick that didn't work out?

A: Wrigley's would be such an example. Through the same type of analysis we thought that the company was well run, had excess cash flow, strong balance sheet, and consistent track record but it was out of favor at the time. We lost 21% from our highest-price purchase and it's down 8% from our average cost. But we still own it and we're adding to the position because it's a long-term holding. We don't think that the business will go away or get obsolete. If we like the long-term business model, we just keep buying the stock.

Q: What are the major challenges when managing money in an all-cap strategy? Is it challenging to follow a large number of companies?

A: The challenge in the past was staying in a sector that was underperforming relative to the other groups but we just changed that perspective. In January this

year we opened it up to multi-cap global and domestic securities. To me it is more challenging to stay in large-cap growth when large-cap growth is underperforming than to pick a good company. It doesn't make sense not to be able to buy a company's stock just because it is smaller.

We only have one fund at Sparrow Capital Management and we want to make money every year, not only when large-caps are in favor. So our fund is for the advisors and planners who want an all-weather fund with consistent track record.

Q: How much international exposure do you have? What portfolio construction rules do you follow?

A: There's no strict norm but in the past we have averaged around 15%. It's all based on the opportunities that present themselves. Our mandate is to be a multi-cap, multi-market fund and, theoretically, we could go up to 100% in international stocks. But since we don't do a lot of trading, the 15% exposure has remained relatively stable.

We have a very low tax profile that's attractive for anyone who's on an after-tax basis. Our turnover this year will be approximately 17% and I anticipate that to drop again next year. I have both my personal IRA money and my personal taxable money in the fund so I have the ability to control the capital gains almost to 100%. The only case when I cannot control them is if a liquidating shareholder forced me to sell. The only disadvantage of being in a mutual fund is that you can potentially be forced to make a change based on some other person's desires.

Q: What are the most important elements of your sell discipline?

A: We sell when the management team is doing things that we don't believe to be adding shareholder value over the long term. For example, when the management of Central European Distribution, primarily an alcohol dis-

tributing company, started to compete in manufacturing, we thought that this didn't make sense in the long term and we sold that stock. In general, we follow the management, the industry, the business, and we have pretty good judgment of what will add stockholder value over time.

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GERALD SPARROW is Chief Investment Officer at Sparrow Capital Management, Inc., a registered investment advisory in St. Louis, Missouri, since 1988, and Chairman and President of Sparrow Growth Fund, a SEC registered investment company, since 1998.

Gerald served as Chief Investment Officer and Director of Buford, Dickson, Harper, and Sparrow, Inc., a minority registered investment advisory, from 1995 to 2005. Prior to joining, he was Institutional Sales Representative for Strong/Corneliuson Capital Management, Inc., in Milwaukee, Wisconsin, from 1987 to 1988.

Gerald holds a BS from University of Missouri, and an MBA from Washington University.

Q: How many stocks do you have in the portfolio?

A: Currently we have 43 positions. It is a concentrated account and our largest position, First Cash Financial Services, represents 4% of the fund. Our second largest holding is United Technologies at 4% of the account. The next largest holdings are Occidental Petroleum at 3.3% and Commerce Bancorp at 3.2%.

Q: What kind of risks do you perceive and how do you monitor them?

A: The risks come in different flavors. The stock market risk is not really controllable because once you're in the stock, if the market drops, you will go down with it. But you can use that to your advantage by knowing the trading patterns and anticipating the weak periods to buy your favorite stocks. The second type of risk is industry-specific risk. For example, the housing market right now is weak and we buy stocks that we like for the long term in the periods when they are trading down.

The third risk is company-specific risk and we try to minimize that by buying companies with strong balance sheets, free cash flows, successful management teams, and shareholder-friendly board of directors that you can trust. So we minimize the overall risk by looking at all three factors - market, industry, and stock and company risk - and also by diversifying the portfolio into 40 different holdings.

Q: You mentioned that you own bonds in the fund. How do you select them?

A: By prospectus we're allowed to buy up to 15% in fixed income although currently we don't own any bonds. But we'd be buyers of convertible securities if we are buying a stock that has a convertible. If we think that the stock will do well, then the convertible should do well and we'll also get the yield and some downside protection along the way. But right now the bond yield is not good enough to pay for the return. **T**