

## Classic Core Value

*If you buy companies at appropriate valuations, you should do better than the market over time while taking less risk. This philosophy may sound simple to understand but is hard to execute. For Richard Earnest, co-manager of the HighMark Value Momentum Fund, it means conservative five-year forecasts on 700 companies, various estimates of their worth, a thorough understanding of the key issues, awareness of the downside risk, and a top-down view on the world.*

**Q: What is your investment philosophy and how it differentiates you from your peers?**

**A:** We are value investors who believe that if you buy companies at appropriate valuations and stick with them, over time you'll do better than the market with less risk. An important part of the process is how we determine the intrinsic value of a business. Our definition of value requires the stocks to be priced at a level where we could buy them with a margin of safety, and generate good returns using conservative forecasts for three to five years ahead.

The second thing we consider is downside risk. Most value investors have to be risk averse, so we pay a lot of attention to risk when we weigh the risk/reward profile of a company.

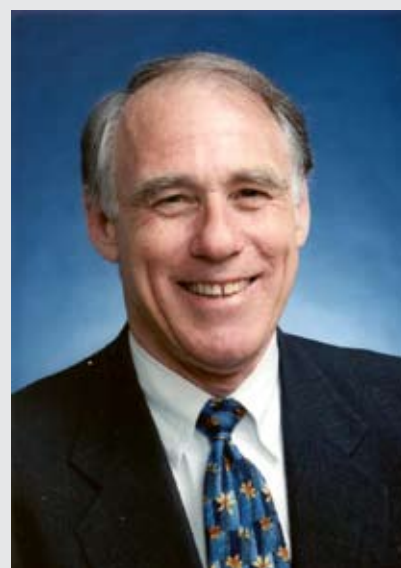
We've had the same process for about twenty years and we have always adhered to it. We differ from our competitors in the way we define 'momentum' investing. Although we have 'momentum' in our name, we wouldn't characterize ourselves as momentum investors. We use momentum to combat the two primary challenges of value investing – buying too soon and selling too soon. We use it both offensively and defensively. We use it defensively during the buy decision to avoid buying value traps and we use it offensively during the sell decision allowing our winners to run as the market recognized the companies improving business fundamentals.

**Q: What kind of value do you pursue? Do you look for deep value, traditional value, or you have your own definition of value?**

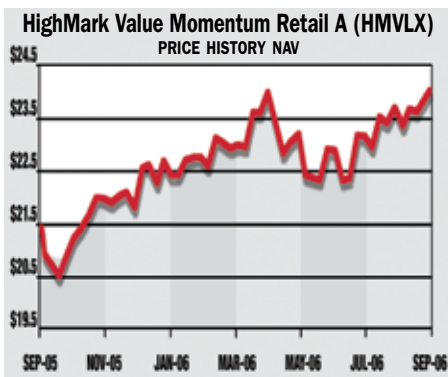
**A:** We swing between absolute value and relative value depending on market conditions. Our universe contains about 700 companies with most market caps over \$2 billion. We exclude fast growing companies like Google and companies that don't have earnings. Almost everything else is included because you don't know when a company like Wal-Mart which has traditionally been considered a growth company or a more traditional value company like Tyco could come down to a price that makes it attractive. It is a flexible strategy that allows us to invest where the chips fall or in the companies that look the most attractive in our process.

**Q: Would you consider Bausch & Lomb, for example, which historically has been a very successful company but its stock collapsed due to problems with a product?**

**A:** Yes, we had no interest in it when it was trading at a very high valuation but the stock has fallen far enough to display the characteristics that would interest us. We don't restrict ourselves to the value stocks in the Russell Value Index. We try to accumulate knowledge about the companies that may come within our universe because it helps the decision-making process to know them in advance.



**RICHARD H. EARNEST** CFA, Director, has been working with HighMark and its predecessors since 1964 where he has gained more than thirty-five years experience in all facets of investment management. Specializing in equity management, Mr. Earnest developed the value momentum style of investing and has managed the highly successful Value Momentum strategy since its inception. Prior positions include a board member of Current Income Shares, a closed-end mutual fund, and Chief Investment Officer of Union Capital Advisors. Mr. Earnest is a member of the Los Angeles Society of Financial Analysts and has earned the Chartered Financial Analyst designation from the Association for Investment Management and Research (AIMR).



**Q: I suppose that the opportunity-based approach provides a lot of latitude in selecting the companies. How do you make the final selection for the portfolio?**

**A:** To define whether we could have a margin of safety and good returns, we project earnings, cash flows, book values, dividend yields and ROE's five years forward for our companies. Then we determine what multiple of earnings, book value, cash flow etc investors might be willing to pay considering the quality and sustainability of the company's business model and the market position five years ahead.

In our view, companies tend to have a basic structure and if the economy operates a certain way, they will usually participate based on that structure. There's value added in the thought process of looking at companies under normalized conditions and how they are likely to be valued under these conditions.

**“We are looking for 12% total return from the current price because we believe that's a reasonable number given the long-term returns of the stock market. Our first test is the ability of a company to demonstrate that kind of return potential based on conservative assumptions.”**

We are looking for a 12% annualized total return over five years in our companies from the current price. We believe that 12% is a reasonable number given the long-term returns of the stock market. We try to estimate how much money we can make in a stock or our upside potential based on conservative assumptions.

The second test is the downside risk. Essentially, we assume that earnings will be disappointing and we try to determine where the stock could trade. We look at various valuation measures, such as price-to-book, price-to-dividend, price-to-sales, price-to-earnings, price-to-cash flow for valuation support in case our long term investment thesis is wrong.

Overall, we don't want to see more than 30% downside price risk. This may seem high but the average in 2000 was 50% and in some areas it can be 70% to 80%. We have a lot of stocks where the downside price risk is limited by the book value, the cash flow, or something to hold the stock in the case of disappointment. There aren't many periods like this with a lot of stocks showing less than 30% price risk, so the environment is attractive right now. Many stocks really haven't moved in price as much as their underlying financials have improved and their free cash flow is strong.

The third area is defining what the stock is currently worth in a change of control. We test that in two ways. First, in our LBO (leveraged buy-out) valuation we try to determine what management could pay to take the company private - taking into account the pre-tax cash flow, the borrowing rate, the risks of that cash, and servicing the debt out of the existing cash flow. The LBO valuation gives us a pretty good base value and when stocks get down to that value, they begin to look attractive.

Then we estimate the private market value to determine a takeover value, which is an assessment what a strategic buyer would be willing to pay for control premium. In almost every case that value is higher than the insider purchase. It gives us a range of what this company might be worth. We don't necessarily expect the company to be bought out but these valuations give us

a lot more confidence when there are disappointing earnings and the stock is under pressure.

After all our screening criteria is met we stress test our assumptions through extensive research and due diligence. We monitor our companies for all types of risk including business risk, financial risk, market risk, management, execution risk, interest rate risk, political risk.

**Q: What is the focus of your research process?**

**A:** A good part of the research is already done in terms of the metrics, so at that point we look at the potential drivers of the current price. In the case of Bausch & Lomb that you mentioned, there's the probability of a series of lawsuits over the product problems they have had recently and that's a tough guess, but you'd have to estimate their vulnerability. Also, we address the issue of accounting standards because they've been criticized over the way they portray their financial statements. That issue may be enough to convince us not to proceed with the stock because, as an investor, it is important for us to trust the management.

We have been shareholders of Merck and we stuck with it even with the Vioxx problems so the lawsuits and the payouts would not necessarily keep us away. But in the case of Bausch & Lomb, I don't know if we'd ever get over the hurdle of their accounting. If a new management comes in to clean house and clean up the books, we'd feel better about the company and may be willing to buy the stock if the price were still attractive.

Overall, our research goes into what we consider to be the important issues for the company, industry and sector. We do our best to get the background, talk to the right people, see how the products are placed against other products, check the store quality, or the manufacturing quality, etc. It depends on what we consider the key issues in that particular company.

We have a team approach with three portfolio managers. The other portfolio managers are Keith Stribling and Todd Lowenstein and each team member has

an equal vote on the stocks that pass our screening process after the due diligence is complete.

We don't visit a lot of companies but we have a fair number of managements coming here. We have research staff in San Francisco of six people with industry assignments, so we always check our knowledge with them. Usually, we can move pretty quickly through the research if we can get an answer to the key questions. For some stocks it may be only a day or two, while for others we may delay the purchase as long as a year if we are having trouble finding the answers to a significant question.

Essentially, our process represents a combination of a top-down and a bottom-up approach. We think that it is important to know what's going on in the world. For instance, about five years ago we believed that industrial America would be a good place to invest because it had been under a cloud for a long time and valuations were low. We felt that the dollar had been too strong for too long, and when it became weaker, it would help many US industrial companies compete in worldwide markets. We had been in a strong consumer environment for some time and we expected the excitement to go away from that area of the market and that investors would be looking for other areas. Our overweight in the industrial area was combination of our top-down view and the companies that showed up meeting all the requirements of our process.

**Q: What are the most important elements of the portfolio construction process?**


**A:** We're broadly diversified and we benchmark to the S&P 500. We usually hold 60 to 90 stocks and our largest positions are typically in the 3% area. We target 1.25% per holding and when it performs well, we may keep buying up to 2% or more. If it goes up to 3%, that's usually because of appreciation. We typically start with half position and keep building it as we learn more. Our turnover has always been low, usually between 10% and 20%. It's been very stable and I wouldn't expect it to change much.

The fund has always reflected traditional value characteristics. Our portfolio's P/E and Price to book ratio is maintained below the that of the S&P 500 and the dividend yield of the weighted average stock holdings is about 50 basis points above the index. Those have been very consistent numbers.

We have a 10% limit on sector over/under weights. For example, if energy is 12% of the index, it could be as low as 2% or as high as 22% of our fund. That's leaves a lot of room to cover most situations.

**Q: What are the major risks you perceive and how do you mitigate them?**

**A:** We do all the tests on various metrics, including standard deviation, beta and tracking error, but I've always felt that the biggest risk is buying a stock that can come apart. So the most important risk control is the price we pay and really understanding what we're buying and its underlying asset value and earnings power. We spend a lot of time trying to make sure that we understand the company, its sources of income, and the things that could change dramatically. It doesn't mean that we cannot make a mistake, but when we do, we've got some pretty careful rules in terms of the price we pay to help protect us.

Constructing the portfolio through buying stocks inexpensively, expecting most of them to go up, and keeping your risk on any name limited, is a major part of our risk control. We believe that the overall selection of good value gives you above average performance over time. We never try to stretch too much and we have rules that keep us from taking too much risk. 

## HighMark Value Momentum Retail A

Symbol	<b>HMV LX</b>
Website	<a href="http://www.highmarkfunds.com">www.highmarkfunds.com</a>
Address	HighMark Capital Management Inc. 350 California Street San Francisco, CA 94104
Tel. No.	800-433-6884
Inception	4/2/1992

### PORTFOLIO

Total Net Assets*	\$31.6
Avg Mkt Cap (\$ Weighted)*	N/A
Average Price/Earnings Ratio	N/A
Average Price/Book Ratio	N/A
Turnover Ratio	18%

### INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$1,000
Min Subsequent Investment	\$100
Min Initial IRA Investment	N/A

### RISK (AGAINST S&P 500 - SINCE INCEPTION)

Alpha	0.24
Beta	0.92
R-Squared	0.86
Ann Std Deviation	7.57
Sharpe Ratio	1.45

### RETURNS VS. S&P 500 INDEX

	HMV LX	Index
1 Year (Cum.)	11.87%	10.79%
3 Year (Ann.)	14.46%	12.30%
5 Year (Ann.)	8.65%	6.97%

### RETURNS VS. RUSSELL 1000 VALUE INDEX

	HMV LX	Index
1 Year (Cum.)	11.87%	14.62%
3 Year (Ann.)	14.46%	17.25%
5 Year (Ann.)	8.65%	10.73%

### FEES AND EXPENSES

Max Sales Charge - Front**	5.50%
Max Sales Charge - Deferred	N/A
Max Redemption Fee	N/A
Total Expense Ratio	1.20%

### PORTFOLIO MANAGER

Team Managed	
<i>*millions **for amount less than \$50,000</i>	
Data through: 9/30/06	
Source: Company Documents; Lipper	

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