

## Condition-Based Investing

*Manning & Napier Advisors has full confidence in its strategies as the firm has applied them for over 30 years across all investment products. Its small-cap fund relies on three separate frameworks to select stocks that can provide growth, deep value, or cyclical value. According to one of its managers, Jeff Tyburski, the key is the bottom-up approach, the consistency, and the risk control embedded in every step of the process, even in the analysts' incentives.*

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

**A:** We focus on absolute returns with a long-term perspective. We have a bottom-up research approach; we're very team and process oriented. The strategy has been consistently applied for over 30 years and we use it in a disciplined way through all the investment products of our firm. I believe that our strategy is our advantage as long as we apply it consistently because that allows us to leverage investment themes and ideas.

The fund is usually classified as small-cap core or small-cap blend but the core orientation is not intentional. We have a bottom-up approach and we're looking for the best ideas, so we don't differentiate between growth and value when selecting the stocks for the fund.

The new ideas are flowing from the various analysts in the research department. All the analysts are covering their assigned industries on a global basis regardless of the country or market capitalization. They're just studying the industries through the lens of our strategies. We use condition-based strategies that we've learned and improved over the years, so we're studying the news flow and the industry conditions to produce bottom-up ideas. We don't start by saying that we'd look at growth, value, developed countries, or emerging countries. It's entirely a bottom-up process.

**Q: Regarding your condition-based strategies, can you describe conditions that you deem important or that have survived the test of time?**

**A:** The three strategies that we have are strategic profile, hurdle rate, and bankable deal. Overall, 'profile' is the strategy that allows us to play the growth of a story; 'hurdle rate' is the strategy that allows us to play cyclical stocks; and 'bankable deal' is our deep value tier. This framework governs our stock picking and keeps us from deviating from our philosophy.

The bankable deal strategy looks like a deep value strategy in the sense that the companies should have something broken in the business model or should be stocks that are out of favor. But we're relying on some substantial inherent value in the company, whether we realize that through restructuring, a buy-out scenario, or a turnaround. We're looking to buy that company at a discount to what we deem is tangible value. Our research has shown that when a company is trading at around 55% of that tangible book value, forces come into play that will catalyze that value. We tend to sell those stocks when they reach around 80% of that fair value.

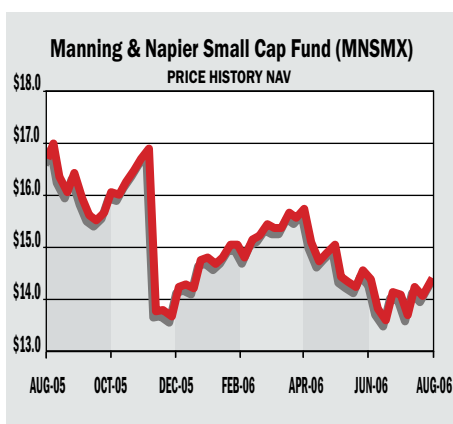
For example, one of our larger holdings is a company called Pathmark Stores, a northeastern supermarket chain with 142 stores. We did a lot of work in the supermarket sector and our view was



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Mr. Tyburski earned both a B.S. in Mechanical Engineering and an M.B.A. in Finance from the University of Rochester, and holds the designation of Chartered Financial Analyst.

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that the supermarket space was a very competitive area. Pathmark emerged from bankruptcy and was trading at about 20% of the value based on sales but it had a lot of compelling characteristics beneath the surface. It had high market shares in some of the most attractive markets and the highest sales density per store of any publicly traded food retailer.

In the worst case scenario, its real estate value was probably worth twice the current valuation and that provided a lot of protection. If it was sold to a third party, it could be worth up to 80% or more. We had a couple of ways to win, so we bought the stock and we've owned it for 2 years. We still see some upside but one source has already come into play as a private equity firm took 50% interest. That highlighted to the market the value of the company and the stock appreciated almost 100%. We're seeing some turnaround but there's still the prospect of being sold to a third party because, eventually, the northeast market needs to consolidate.

The profile strategy allows us to invest in growth stories where a company controls its own destiny. That strategy deals with growing companies that have high and sustainable margins because of pricing power. They must be doing something unique that gives them a strong competitive position, regardless whether this is a differentiated product, a truly innovative product, or a critical application. They can also sustain those margins because of barriers to entry, such as strong

positions, high switching costs, a strong brand name, or scale in distribution or manufacturing. We also look for growth in the industry but, hopefully, the company itself is providing growth and taking market share.

The hurdle rate strategy allows us to play cyclical names and it is a strategy of basic economics. Money flows where the returns are, so when times are good and returns are high, money are drawn to the industry and people tend to over invest. Then you'll have the slug of new capacity, returns start falling, and a very predictable supply-side response follows. High-cost capacity will have to be closed and you may even reach the point of bankruptcies in the industry. That's the time when we tend to buy - when low returns in the industry have discouraged new suppliers. And we'll sell before the next peak.

We focus on the supply side because we think that it is more predictable. We acknowledge that we're not going to predict short-term returns and demands, but if we can find an industry that's been under-invested and where the supply side looks very attractive, then we can take a position with confidence. It's a good fit for commodities because with commodities those conditions are very visible and there are barriers to entry.

**Q: But when bankruptcy is imminent, even if the break-up value is higher, usually the debt holders benefit from it, not the shareholders. How do you protect them in such situations?**

**A:** That protection is embedded in the way we value the company. In other words, there should be enough to cover the obligations to debt holders and the stock holders. Also, we're not looking for the company to necessarily break up, but that's what grounds the valuation.

In the Pathmark example, we considered whether the company could make it on its own or if someone would buy the entire company and probably sell off some of the stores. It's really difficult to get

green-field retail space in that area, so in the worst case scenario the company would still have a lot of value. Because we focus on individual industries and because our research coverage is global, we can use that as a learning experience, positively or negatively. Someone who specializes in food retail may have missed that potential catalyst but we're looking at the entire picture. Also, we're not looking specifically at underlying asset values; we have another valuation metric to get us comfortable with the downside. We were comfortable with the cash flow history of the firm and the industry that supported the potential buyout.

It's important to make the distinction that while the bankable deal strategy looks like a framework for analyzing deep value situations, it's not driven by price. Our investment case depends on some catalyst to realize that value and that keeps us mindful of value traps. It is the potential catalyst that attracts us to the stock, not so much the price.

**Q: What are the unique characteristics of your research process?**

**A:** We approach new ideas as if we're going to purchase the entire company. We're very thorough in our research and we do a lot of due diligence work to understand every aspect of the story, including risks and potential rewards. We're divided internally into five sector groups and when we come up with an idea, we'll do our work anyway we have to.

We attend conferences, meet managements, and do our own grass roots research. All sector groups meet every week, sometimes more often than that. Once we reach our thesis, we prepare an internal report outlining the thesis and how the investment idea fits within the framework of our investment strategies. Each idea presented has to have a partner analyst and that's a check on the work you've done.

Once we have the final 'buy' recommendation approved at the group level, we have it presented to the portfolio manag-

ers for review. Then we'll go back to QA and discussion to see if it makes sense from a strategy standpoint and if it fits with the pricing. Then we'll make our decision in terms of how much and when to buy.

But the important thing is that we're studying these industries through the lens of the strategies. Frankly, I don't need to know all the personalities of all the management. I think Wall Street often gets a bit too enamored with personalities, while we just follow the industry conditions. That keeps us less biased and we can plough through a lot more information. We use Wall Street research but only because it's a great source of data, not because of the opinion or the short-term recommendation.

Another differentiating factor is our unique incentive structure that is a risk management tool and makes us very bottom-up focused. We're paid on the stock picks that we have made, so we want to do a lot of due diligence to make sure that our stake in the portfolio has a good upside/downside ratio.

**Q: Would you explain the portfolio construction rules that you follow?**

**A:** As a small-cap fund, our benchmark is the Russell 2000 index, but we're not benchmark sensitive. We don't have rules that govern our underweight or overweight. The analysts are motivated to bring their best ideas, and if those best ideas result in a significant under or overweight in a sector, we're happy with that. Our stakes just reflect the fact that the analysts are incentivized for absolute returns and best ideas, not to buy for the sake of looking like a certain benchmark.

We have about 100 holdings, each averaging about 1% of the portfolio, but that varies. Running a small cap fund poses certain challenges, such as concentration and liquidity, and we are not taking significant stakes in any individual company. But that's not such a big issue nowadays as a lot of small caps are de-

finied in the billions of market cap. The turnover of the fund is about 40%.

**Q: What is your view on risk control?**

**A:** I think that our investment process naturally controls risks and it's our biggest risk control. We don't look too much at things like tracking error. We do have a quantitative strategies group internally that provides portfolio metrics for us, but we're stock pickers and we want a portfolio compiled by our best ideas. So we let the process govern how we monitor risk at the individual idea level.

With that being said, we are well aware of our sector weights and the index to determine some underlying drivers. If we see a sector that's performing and we're underweight, we'll have discussions at least to learn more about it. But ideas come from bottom-up analysts, not from wide sweeping macro calls that could really be wrong.

One of the byproducts of our investment strategy is the fact that after we're done following a stock, we develop monitoring points. These are the key factors that drove our interest in the stock and we follow them to make sure that the story is consistent and is within the framework of our strategies. That keeps us governed when to buy and when to sell and not to get too emotionally attached to a stock.

Our recommendations go through multiple drafts and our colleagues help us weed out problems and focus on the true questions to ask and monitor. When we recommend the stock, there is a voting process and a review team. The portfolio managers are in constant contact with analysts to discuss questions and views. But the analysts are the ones keeping track of their ideas and staying on top of them. Once an idea is approved, the analysts maintain responsibility and the performance of that stock is in his compensation. At the end of the day, the portfolio reflects the composite of the best ideas of our team and we're comfortable with that. **T**

## Manning & Napier Small Cap Fund

### FUND FACTS

Symbol	MNSMX
Website	<a href="http://www.manningnapieradvisors.com">www.manningnapieradvisors.com</a>
Address	Manning & Napier Fund, Inc. P.O. Box 805 Fairport, NY 14450
Tel. No.	800-466-3863
Inception	4/30/1992

### PORTFOLIO

Total Net Assets *	\$ 149.98
Turnover Ratio **	55 %

### INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$ 2,000
Min Subsequent Investment	\$ 0
Min Initial IRA Investment	\$ 2,000

### RETURNS VS. RUSSELL 2000 TR IX INDEX

	MNSMX	Index
1 Year (Cum.)	8.06 %	9.36 %
3 Year (Ann.)	17.61 %	14.45 %
5 Year (Ann.)	10.51 %	10.35 %

### RETURNS VS. S&P 500 INDEX

	MNSMX	Index
1 Year (Cum.)	8.06 %	8.88 %
3 Year (Ann.)	17.61 %	10.95 %
5 Year (Ann.)	10.51 %	4.65 %

### FEES AND EXPENSES

Max Sales Charge - Front	0.00 %
Max Sales Charge - Deferred	0.00 %
Max Redemption Fee	0.00 %
Total Expense Ratio	1.19 %

### PORTFOLIO MANAGER

Team managed	
* millions	** 12/05
Data through:	8/31/06
Source:	Company Documents; Lipper

**Ticker staff searches for mutual funds for their consistency in performance and durability of investment style.**

**Our interview covers investment philosophy and strategy, research process, portfolio construction and risk control for funds. Through an interview we uncover long-term strategies and processes that help to generate long-term returns.**

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