

Small Wonders

Investing for the BB&T Small Cap Fund is similar to going to the mall – people look for high quality products and prefer to pay less. With his focus on valuation, portfolio manager John Kvantas is willing to wait for companies with a quality business to go on sale. It is one of the Fund’s core beliefs that the strong and conservative balance sheet gives these undervalued companies the capability to ride out difficulties on the operational side.

Q: What’s your investment philosophy?

A: There are two investment criteria that we look at - the quality of the business and the price we pay for it. We are looking for financially strong, well-run companies that are going to give us above average returns over a longer period of time. Our turnover is 20%-30% on average with a three to five year average holding period.

Valuation is very important to what we do. We are looking for companies that are on sale, just as when you go to the mall. Generally, people are looking for a high-quality product, but they prefer to pay less for it than more. While some may not be willing to wait very long, we tend to be more patient and are willing to wait for a particular company to go on sale.

As far as quality of the business, we are looking for companies that produce solid returns on equity and returns on invested capital, and companies that produce strong cash flow. We are looking at cash flow from operations, less capital expenditures, trying to see what kind of cash the company can produce in a steady economic environment as

opposed to a high-growth environment. We also tend to look at companies that have lower financial leverage (lower debt to total capitalization) than the average company in the particular sector.

Q: How do you find these companies?

A: We use quantitative and fundamental analysis. We use a screening process to filter out companies. We’ll first try to find quality companies, and then we’ll try and determine if they appear over or undervalued, but not cheap. If something is cheap you don’t want to buy it because it’s probably priced that way for a reason. So we are looking for undervalued companies, where there is a quality business that appears undervalued based on our analysis.

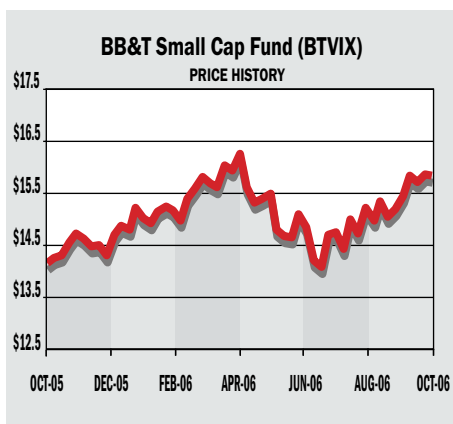
Q: How is your research process organized?

A: We have a screening process where we screen for companies on various financial metrics. We’ll go through that process several times a month. We also screen for quality characteristics. We look for strong management teams. Liquidity is an issue we have to deal with in the small-cap world. Then we look at the industry each of the companies par-



JOHN KVANTAS has investment experience since 1987. He has been employed by BB&T since February 2003 and manages the BB&T Small Cap Fund since May 2003. Mr. Kvantas earned a B.S. in Accountancy from the University of Illinois Champaign-Urbana and an M.B.A. from the Fuqua School of Business, Duke University. He is a Chartered Financial Analyst and a member of the North Carolina Society of Financial Analysts.

“A lot of times you can find more mis-priced securities in the small cap market where you can generate returns between 10% and 30% in a short period of time, something very hard to do in the large cap universe of stocks. ”



ticipates in and try to get some understanding if the economics of a particular industry is favorable or unfavorable. We don't necessarily avoid those with unfavorable economics, but we take that into account with respect to valuation.

If a company passes our general screening process, then we do a little more detailed work and we perform fundamental analysis. We read the detailed annual and quarterly financials, we listen to quarterly conference calls, we visit management teams when appropriate. Then we try and put a valuation on the particular company. We use a discounted cash flow approach. We have our own model that we have developed over time and we use that to make financial projections for a particular company. Based on our analysis of the company's historical performance we make estimates of the company's future sales growth, profit margins, capital expenditure requirements and working capital requirements. We use this process not just to determine an estimated value of the company, but also to gain a good understanding of the company's operations.

We perform sensitivity analysis on the output of our valuation model. We try to get more of a range of values rather than a specific price point. In general,

we are looking for 25% to 30% upside from our valuation.

Q: Do you generally combine the fundamental analysis with the technical analysis?

A: We look at fundamentals to analyze the financial history of the company, but we don't really use technical analysis in any way to determine whether or not we are going to buy or sell. We do the fundamental analysis and we do the valuation work. We use a discount cash flow approach, but we'll also look at price multiples of various kinds depending on the industry the company is in to make sure that the cash flow analysis seems reasonable.

Q: Where do you find inefficiencies in the marketplace? Does market cap play a role in your search?

A: We spend a lot of time looking at a lot of companies. We may spend 5 – 10 minutes with a company reviewing it quickly, and if it doesn't meet any of the fundamental parameters, we won't spend any further time analyzing that company. If something looks interesting based on the fundamentals, we'll do a little more work on it. After that level, if it still looks attractive, then we may start to read and analyze the 10Ks, the 10Qs and the proxy statements and start to develop a discount cash flow model to get a feel for what's the sensitivity to different variables for a particular company. Then we delve into it even more and we may determine that we'd like to own a particular company at some point, but it just doesn't seem the right price right now. So we'll continue to monitor that particular security and buy it if it goes on sale.

Other analysts and I interact on a daily basis, so we have a very tight niche here

as far as being efficient from a research perspective. We screen for companies with \$1.5 billion and less, down to \$100 million market cap. There's less efficiency there since Wall Street doesn't always cover a lot of the smaller companies, or if there is any coverage it's maybe a couple of regional brokers. Many times you can find more mispriced securities in that range.

We tend to avoid companies under \$100 million in market cap. When you start getting into market caps below \$100 million, you sometimes see companies that might be a little more dicey as far as a smaller revenue base, customer concentration, ability to withstand a catastrophic event or downturn in the economy.

Q: Can you give us an example of an undervalued company that has become a holding in the fund?

A: One of our bigger holdings is P. F. Chang's China Bistro, Inc, the restaurant company. It was considered a high-growth company before mid-year 2005 as they were building out the restaurant's Bistro and take-out Pei Wei concepts. The new take-out concept was not growing as expected and brought the stock down. Before the year 2005, the stock did not pass our screening process because it was too expensive. It was a solid company, but we didn't want to pay what the market was asking for that type of business.

In mid '05 when the Pei Wei concept started having enough volume to make a difference in the results, the company had a couple quarters of negative same-store sales growth on the Pei Wei side and missed Wall Street expectations.

Well, the growth story fell apart and the stock went from the mid \$60s in mid '05 to \$30 earlier this year and it got interesting to us as it started going below \$50 because it started to hit some of our high-quality screens. Our analyst had been following the company for a while and liked the concept. The company produces very good returns on investment when they open a restaurant. So that was a quality business that was approaching a point where we thought it was undervalued. We were doing the work on it and once the stock fell below \$40 we initiated a position and kept adding to it as it fell to \$30.

Q: Can you give us another example of the difference between undervalued and cheap in your way of calculating it?

A: Most of our opportunities come when a company stumbles for a quarter or two. We will look at those stumbles and what causes them.

Let's take Kronos Software, as an example. They are a workforce management software company and have a good share of the market in the industry. They had a couple of quarters where they missed earnings expectations due to lower than projected sales. Orders got pushed off to the following quarters and with technology and particular software stocks, this business can be lumpy due to those orders that come in or get pushed off by customers in any particular quarter.

Kronos has a growing market share in that business. The whole workforce management market is growing very well, as more and more companies understand how managing the workforce pro-


cess can save them a lot of money with very little investment. Kronos has a very strong balance sheet and good return on equity. We found that the couple of quarters of missed earnings, where they had stumbled, were bumps in the road that the company had encountered. These bumps were not any sort of indication that the company had a long-term problem selling its software. In our belief, Kronos became an undervalued stock as opposed to a cheap stock as its stock price was hit when it missed earnings expectations.

Q: What kinds of risks do you monitor and what do you do to mitigate them?

A: We use a bottom-up approach, but we are aware of our sector weights compared to the Russell 2000 index.

Our fund is diversified. We limit our largest holding to 4% and right now our biggest holding is closer to 3%. With approximately 90 names in the fund, the average position size is a little over 1%.

We try and limit the downside risk with the valuation work that we do, using reasonable assumptions and not just continuing a growth mode that a company may have been in over the last year or two. We try and normalize earnings, cash flow, returns and margin assumptions.

Companies go bankrupt because they don't have enough time to fix operational problems because the balance sheet is potentially overleveraged. If a company has a strong and conservative balance sheet, it gives it the capability to ride out difficulties on the operational side that could come up. A frequent occurrence with smaller companies. We search for companies with conservative balance sheets. 

BB&T Small Cap Fund

FUND FACTS

Symbol	BTVAX
Website	www.bbtffunds.com
Address	BB&T Asset Management Inc. 434 Fayetteville Street Raleigh, NC 27626
Tel. No.	800-228-1872
Inception	5/19/2003

PORTFOLIO

Total Net Assets *	\$ 124.1
Avg Mkt Cap (\$ Weighted) *	\$ 1,200
Average Price/Earnings Ratio	16.61
Average Price/Book Ratio	1.95
Turnover Ratio	45.01 %

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$ 1,000
Min Subsequent Investment	\$ 0.00
Min Initial IRA Investment	N/A

RISK (AGAINST RUSSELL 2000 VALUE TR INDEX)

Alpha	0.08
Beta	0.87
R-Squared	0.94
Ann Std Deviation	11.29
Sharpe Ratio	1.17

RETURNS VS. RUSSELL 2000 VALUE TR INDEX

	BTVAX	Index
1 Year (Cum.)	13.71 %	22.90 %
3 Year (Ann.)	16.78 %	17.91 %
5 Year (Ann.)	N/A	17.52 %

RETURNS VS. S&P 500 INDEX

	BTVAX	Index
1 Year (Cum.)	13.71 %	16.34 %
3 Year (Ann.)	16.78 %	11.44 %
5 Year (Ann.)	N/A	7.26 %

FEES AND EXPENSES

Max Sales Charge - Front **	5.75 %
Max Sales Charge - Deferred	1.00 %
Max Redemption Fee	0.00 %
Total Expense Ratio	1.29 %

PORTFOLIO MANAGER

John Kvantas	5/19/2003
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* millions ** for amount less than \$50,000

Data through: 10/31/06

Source: Company Documents; Lipper

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