

Risk Aware Small-Cap Growth Managers

Most people would expect small-cap growth funds to be always looking for the next big thing and to invest in hundreds of stocks to find the next Google. This one is different. Managed with an institutional approach, the fund focuses on the high-quality businesses and invests for the long term. Always aware of the risks, the fund has fewer names than its peers as it poses a higher level of confidence in each name.

Q: What is the investment philosophy of the fund?

A: We are long-term investors and we believe in constructing well-diversified portfolios of high-quality companies. We believe that in the long run earnings drive stock prices higher. If we can correctly identify a company's earnings growth and pay a fair price for it, then the earnings will do the work over the long run.

There is both a qualitative and a quantitative support for that quality tag. Quantitatively, we look at balance sheets relative to the peers, at the margin structure and the returns for shareholders. Qualitatively, we form an opinion on the management and their business strategy.

Being a small-cap growth manager focused on high quality stocks sounds like an oxymoron, but it's not. We take a long-term, institutional approach versus attempting to be the hot fund of the month or quarter. Some managers may prefer to take big bets in speculative stocks and or to chase momentum from one sector to then next. This can lead investors to perceive small-caps as an aggressive and low quality asset class. But our research continually results in the identification of high-quality companies, with sustainable competitive advantages that can translate them into strong earnings growth.

We try to build a portfolio with an average earnings growth rate of about 20%.

Over the long run, we're trying to capture two-thirds to three-fourths of that growth in stock price appreciation. IF we accomplish that we feel we will beat the long term returns in our asset class and our peers.

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

A: What differentiates us is our approach to diversifying that doesn't just focus on sector weights. We diversify by the growth rates of the companies. Our strategy is to own a stable of stocks with thoroughbreds, pacers and mules.

The mules are companies growing at 10% to 15% a year. In this segment we tend to find regional banks and industrials to name a few. They are not necessarily defensive in nature, but may just compete in more mature industries. The pacers are companies growing at 15% to 20% a year, such as business service companies, for example. The thoroughbreds are more rapidly growing companies, including technology and healthcare.

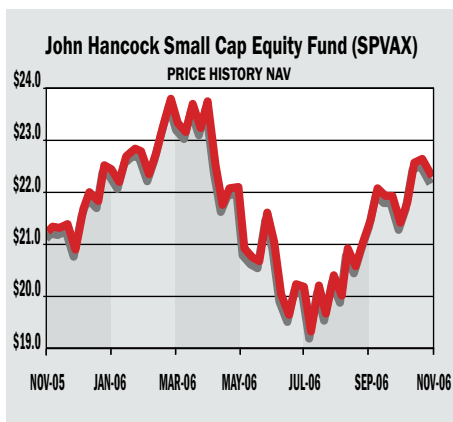
When we diversify the portfolio, we're not just doing it by industry or sector, but by the types of companies we have in each sector. We want to avoid being 100% in thoroughbreds as that would create too much volatility. We also can not be 100% mules because we wouldn't be able to get overall average earnings growth of the portfolio up to our goal of 20%.



ALAN E. NORTON, CFA, is a vice president, portfolio manager and team leader for John Hancock Funds' small- and mid-cap-Growth team. The team manages the John Hancock Focused Equity Fund and John Hancock Small Cap Equity Fund. Prior to joining John Hancock Funds, Mr. Norton was senior portfolio manager at The Colony Group, a high-net-worth investment management company. Previously, he was a portfolio manager and director of research at Congress Asset Management, an institutional and high-net-worth investment manager. Mr. Norton began his investment career in 1987 with Fidelity Investments.

Mr. Norton received a B.A. from Trinity College in Hartford, CT. He also earned his M.B.A. from The Babson Graduate School of Business in Wellesley, MA. Mr. Norton is a Chartered Financial Analyst.

“We’re not momentum investors and we feel a long term approach is the best way to capture the returns that the growth in earnings will generate.”



We don't manage to certain percentages in each type of name, but we do monitor it to ensure that in different market and economic environments those categories are representative of what is appropriate. We currently believe that the economy will continue to grow and that at some point growth stocks will begin to outperform value and defensive strategies. Four years ago there was less certainty about the economy and we had a heavier weighting in the pacers and the mules. That's also a way to approach risk.

Q: Why did you set your earnings growth benchmark at 20%?

A: Henry Mehlman and I have been managing money together for seven years. We were intent on constructing high quality growth portfolios that maximized returns while limiting risk. Our fundamental company research, combined with specific portfolio risk constraints, indicated that a portfolio with an approximate 20% forward earnings growth rate held an attractive balance between growth and risk.

There are a number of reasons why you may not capture that 20% earnings growth. We strive to correctly identify a company's earnings power and to value it correctly. However, companies can deviate from their original business strategies or new competition can erode competitive advantages. Sectors can fall out of favor, which impact specific stock and market markets can quickly change as we've seen in 2006. But the goal of capturing the two-thirds to three-fourths of that growth incorporates many of these unforeseen risks.

As growth managers, we are naturally attracted to higher than average market growth rates. Compared to some of the indices, we have higher expected earnings growth and higher P/E multiples, but we tend to have lower PEG ratios than the market. In other words, we're looking for the growth but we pay a lot of attention to valuation.

Q: How do you define small-cap and how do you define growth? Is the 20%-figure on historic or forward-looking earnings?

A: We define the universe as \$100 million to about \$1.5 billion in market cap. Our average market cap has been roughly in line with our peers; at the end of June our average market cap was just under \$1 bln, similar to the Russell 2000 and 200 Growth. The growth rates are 3 to 5 year forward-looking growth rates. About 90% of our companies have had solid profitability records in the years prior to owning them, as well.

Q: How do you deal with small-cap specific issues such as the lack of coverage or liquidity?

A: We have a fundamental, bottom-up approach, and last year our four-person team, that covers both small and mid-cap stocks, met the managements of over 600 different companies. We're not afraid to buy companies that don't have any Wall Street coverage and about 40% of the names we own have what we consider to be minimal coverage, or less than four regional firms covering the stock and none of the majors.

Less coverage means more work, but we feel that provides us with an information advantage because we take the time to learn the stories, know the managements, and visit companies while other people can't.

Liquidity is important and it can affect position size. Our strategy is to have initial positions of equal weight. The only exception is that sometimes we may have to take less than an optimal position because of liquidity. We have to be comfortable that we can build a position and get out when we have to. If we can't

buy at least 0.5% of the fund's total assets, then we don't even bother buying that name as the time and resources it takes to cover the stock are not justified by the impact it can have.

Liquidity improves, however, as more research firms pick up coverage of a stock or if it is added to a small cap index such as the Russell 2000. This creates incremental demand stock and quite often improves the multiple.

Q: Could you give us examples of how the information advantage has worked out in your favor in the past?

A: Currently we own a company called Raven Industries based in South Dakota. We learned of them about three years ago by screening for 20% earnings growers that had no street coverage at the time. This was despite the company having been around for 50 years and the fact that the stock had more than doubled in the previous two years. We took some time to research the company in late 2003, trying to understand their business. Essentially, they have four business lines. Their original business was making high-altitude research balloons for NASA back in the 50's and the 60's. In the mid 90's they had become a mini-conglomerate, owning 11 different businesses. Unfortunately they were not earning an appropriate return on capital for the investments they had made.

In the late 90's they called in Holt Advisors, now owned by Credit Suisse First Boston. Holt focused on returns on invested capital and advised Raven on how to improve their returns. Management successfully implemented the recommendations and began shedding underperforming segments in the late 90's. In the last 6 years Raven has grown their earnings more than fivefold. As the company's cash flow began to grow, they used excess cash to buy back stock. Because they were still unknown, they were able to buy back stock in the public market at book value. The stock now trades at close to 6 times book value. Book value is not a metric we use as growth manag-

ers, but it gives you an idea of how cheap the stock was, partly because many people did not know the story.

We took the time to go through the different business units, thinking that there were some secular drivers there. For example, they have a growing business in engineered films where the products are sold to the energy, agricultural, and housing industries. They are one of the few suppliers of disaster film for hurricanes. In late 2004 they began to get more coverage because analysts' attention was drawn by the plastic film orders following the 2004 hurricanes season.

One analyst picked up coverage with a sell based on the belief that the 2005 hurricane season would not match 2004. The analysis also did not fully appreciate the other growth drivers for that business segment. The stock sold off on this new coverage, but we bought more because we knew that the hurricane business was small and transitory and was not the real driver for Raven. They have continued to grow earnings and we still hold the stock. Liquidity has also improved, as coverage has expanded and the stock is now included in the Russell 200. Originally we bought the stock under \$15 and now it is about \$30. We've taken some profits when the stock has appreciated rapidly and we've added some back around our core position when we think it's oversold.

Q: Would you describe your sell discipline?

A: A great deal of our turnover comes from what we call trimming and reseed-ing. When a position becomes 3% of the portfolio, we monitor it closely and generally take profits. We don't let any single name dominate the portfolio, so our top ten names are generally less than 25% of the fund's assets. After we have trimmed some of our winners, we often look to rebuild position in names that may be out of favor.

Fundamental disappointments, particularly when we feel the original in-

vestment thesis may no longer be valid warrant immediate consideration for sale. Short term or transitory disappointments will trigger a review, but we like to circle back with company management and try to fully understand a situation before selling.

Q: Based on your experience, how much of the sector knowledge is critical? Or is the company-specific information more important?

A: We find small-caps exciting because of the company-specific knowledge and finding the companies before other people do. You don't always have to be the first one there, but you want to be there before the crowd. Knowing the company is critical because in the current market environment, you have to either trade rapidly and frequently or have a longer term perspective. As a long-term manager, we think we can make the big returns come from buy and hold approach. If a company misses expectations by a penny because they are hiring or investing for future growth, their stocks can sell off 10 or 15%. We think our shareholders benefit more by seeing a stock double or triple over three years rather than selling a stock down 10% and trying to get back in.

Q: How many names do you have in the portfolio and what's your turnover?

A: We have held between 70 to 90 names over the last four years. The turnover has been between 50% and 60% per year on average, lower than most small-cap growth funds. We tend to have fewer names and lower turnover because we're trying to spend more time on the names we own to establish a higher level of conviction.

Q: How do you monitor and control the risks?

A: We control risk by analyzing stock weights, sector weights and by diversification of growth rates. We also place a lot of importance on a company's financial strength and quality, as well as the liquidity in the company's shares. Our sell discipline helps to maintain this balanced approach to risk. **T**

John Hancock Small Cap Equity Fund

FUND FACTS

Symbol	SPVAX
Website	www.jhfunds.com
Address	John Hancock Group 601 Congress Street Boston, MA 02210
Tel. No.	800-225-5291
Inception	1/3/1994

PORTFOLIO

Total Net Assets *	\$ 22.2
Avg Mkt Cap (\$ Weighted) *	\$ 931.5
Average Price/Earnings Ratio	29.46x
Average Price/Book Ratio	5.12x
Turnover Ratio	38 %

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$ 1,000
Min Subsequent Investment	\$ 0
Min Initial IRA Investment	\$ 500

RISK (AGAINST S&P 500 - SINCE INCEPTION)

Alpha	-0.44
Beta	1.12
R-Squared	0.89
Ann Std Deviation	15.01
Sharpe Ratio	0.64

RETURNS VS. RUSSELL 2000 INDEX

	SPVAX	Index
1 Year (Cum.)	10.00 %	19.98 %
5 Year (Ann.)	6.01 %	13.75 %
10 Year (Ann.)	10.99 %	9.84 %

RETURNS VS. S&P 500 INDEX

	SPVAX	Index
1 Year (Cum.)	10.00 %	16.10 %
5 Year (Ann.)	6.01 %	14.97 %
10 Year (Ann.)	10.99 %	11.96 %

FEES AND EXPENSES

Max Sales Charge - Front **	5.00 %
Max Sales Charge - Deferred	1.00 %
Max Redemption Fee	0.00 %
Total Expense Ratio	1.42 %

PORTFOLIO MANAGER

Alan Norton	2002
Henry Mehlman	2002

* millions ** for amount less than \$50,000

Data through: 11/30/06

Source: Company Documents; Lipper

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