

Searching for Undiscovered Value

The fact that expectations are usually priced in a stock is a simple truth that most investors tend to neglect. That helps Warren Koontz, the manager of the Loomis Sayles Value Fund, to find undiscovered value in areas not typical for value managers. With a portfolio that's constructed on the basis of individual ideas, and a time horizon of two to three years, the fund benefits from the volatility created by the short-term mentality of the market.

Q: What is the investment philosophy of your fund?

A: As a manager we look for stocks trading at bargain to the value of its business. I believe that investing in companies that sell at a discount to intrinsic value will produce exceptional long-term returns over a market cycle. We believe that value can be found in all sectors of the market, so we are looking where our competitors in the value space may not traditionally look in trying to find positive potential that is undiscovered. As a fund manager we pay attention to the price we pay for the company's earnings and cash flow growth.

Q: How do you define intrinsic value?

A: We look at value from several dimensions, including discounted cash flow, stock price to earnings ratios and traditional valuation metrics, breakup valuation or liquidation valuation, to find undervalued stocks with good potential. Some industries and sectors are influenced more by certain valuation parameters than others. For example, when valuing financials, the weight we give to certain parameters would be different from the weight that we'd use for the telecom and media space.

Q: What are the key elements of your investment process?

A: The first step is to figure out what a company is worth, or what its intrinsic value is, and then compare that to the current stock price. We want to know what the market is discounting while keeping its expectations in mind. We look for stocks that are undervalued and have low market expectations. When expectations are low, people aren't looking for the next positive catalyst.

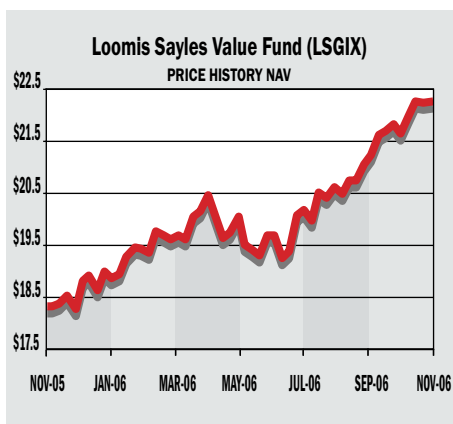
We also spend a lot of time considering the downside scenario. We have a healthy respect for the fact that we might not always pick the exact bottom. There is always a chance that there is still downside left when buying a turnaround candidate or a contrarian idea.

When we have figured out intrinsic value, current expectations and possible downside, we then have a good idea about the potential risk and reward. We want to have an upside of at least 25% from today's price and we want a downside of 10% or less. Through our calculations we aim at purchasing a stock during the time a downside scenario occurs.



WARREN KOONTZ is a vice president of Loomis, Sayles & Company and portfolio manager in the Loomis Sayles Large Cap Value Group. Prior to joining Loomis Sayles in 1995, he served as a senior portfolio manager with Comerica Bank where he was responsible for the management of investment relationships and was actively involved in the investment policy committee. Before his tenure with Comerica, Warren served three years with The Jeffrey Company, a private investment firm where he was the chief investment officer. Additionally, he spent six years with the Public Employees' Retirement System of Ohio as a securities analyst and assistant investment officer. Warren is affiliated with the Association for Investment Management and Research and the Boston Security Analysts Society. Warren earned a BS and an MBA from Ohio State University.

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Q: How is your research process organized?

A: We are fortunate enough to have a very experienced team. I'm head of the Value Group, Jim Carroll has about 30 years of experience, and Art Barry has been in the business for about 12 years. We complement each other and value each other's opinions.

We have an entirely bottom-up approach and look for individual stocks that are underappreciated by the market. Our portfolio is constructed one stock at a time and the weightings are dictated by where we're finding good value opportunities. Areas where we might find a lot of interesting ideas are likely to be an industry or a sector that we'll overweight versus the benchmark. Areas where we do not find a lot of ideas, we're likely to underweight.

We understand the impact the economic environment can have on industries and companies but we try not to predict what the top-down factors may bring. Fundamental analysis is of primary importance for us and we work with a number of senior equity analysts. It's a process in which we attempt to identify a company's worth and try to project its earnings and cash flows into the future.

We like to see strong cash flow from companies. If a company is in the bottom of its cycle but has good cash flow, even if it's not reflected in earnings, we believe that a good management team will eventually put that cash flow to work profitably and in time improve the rate of return.

Q: Do you find the meetings with managements valuable?

A: Yes, we find them very valuable. I've never found meetings to be a disadvantage because they usually lead to a more qualitative understanding of a management team that is not readily available otherwise.

We try to determine if a management team has a good grasp of its business and a good vision for the future. Our findings eventually help us make a decision about the long-term potential of the company. However, it is the case now that many management teams can no longer disclose as much as they did previously.

I've been in this business for 24 years and I feel that over the years the investing time horizon has compressed. I call it the 'hedge fund impact', which means that there is an increasing short-term mentality on the part of investors who are playing the next quarter's earnings numbers. This mentality drives stock prices to extremes in the short term and is a great benefit to us as value managers with a reasonably longer time horizon. Although we value companies on a two to three-year horizon, it is very rare that we have to wait two to three years for the value to be recognized. When we're buying stocks with lower expectations, people aren't expecting a positive event, and we use a lot of the volatility in

individual names that the shorter-term mentality creates.

Q: Can you give us some examples of ideas that turned into holdings through your research process?

A: One name that has been played out in the press quite dramatically is Microsoft. If you look at Microsoft on any valuation metric, it looks cheap relative to its history. But does it have an absolute low P/E relative to the marketplace? No. When we bought the stock, it sold at a slight discount to the market multiple, but relative to its history, it was quite depressed, and relative to its earnings potential it looked very attractive. So we bought Microsoft on the bad news and the positive developments surprised everybody.

That is a good example of looking for value in every sector, including sectors that traditional value managers may overlook. We valued the company at a fairly decent upside to where we bought it. We felt that expectations were very low and the downside at that price was very manageable and very little, as the earnings and the cash flow generated over time were substantial.

It's still probably not something a growth manager would buy these days because the growth metrics are slower than they once were, but we think that Microsoft in the next couple of years can easily record double-digit earnings growth.

Q: Do you specifically look for turnaround situations or is the price drop the catalyst of your interest?

A: It's both. Sometimes there isn't such a dramatic fall in the stock price. A stock may start to screen well on various valuation metrics after it has fallen for some

time and people are slowly giving up on the name, so we'll start analyzing it. There are also situations like Microsoft, in which we have been looking at a stock when an event-driven opportunity comes up quickly and gives us a great entry point. I can't say that every stock that we have included in the portfolio has had a dramatic fall in stock price. But we monitor these holdings over time through a quantitative tool, and our interest is driven by the companies that start to screen attractively.

Q: How do you approach portfolio construction?

A: The portfolio is constructed entirely through a bottom-up process. We don't make any top-down plays based on economic forecasts or industry outlooks. It's the exact opposite because you may often find value where the economic environment has been poor.

Right now we have about 58 names in the portfolio, so it's not overly concentrated but it doesn't include too many names either. We want the stocks to be able to have an impact if we are correct in our analysis. We haven't moved out of that 55 to 60-name range for the past couple of years. In certain environments, when there may be a broad array of mis-priced sectors out there, we may include a larger number of names. For example, in years 2001 and 2002, the market was very concentrated on the technology and internet sectors, but we felt that there were a lot of other value opportunities available. So when the bubble burst, we had about 78 names in the portfolio.


Q: What's the average turnover of the fund?

A: Our turnover depends on the market environment but it's somewhere in the 25% to 40% range. In some cases, we may be holding a name that has had a good run and may even present additional upside, but it is not as attractive as a stock we have identified as having strong upside potential. In these cases, we will cut back or sell the holding completely to allow us to add the new company to the portfolio. This process allows us to use the profits from holdings we are not worried about because they don't have as much upside potential as the company we want to add. That approach keeps the portfolio fresh with a very manageable amount of turnover.

Q: What kind of risk do you monitor and how do you mitigate them?

A: We run a diversified portfolio consistent with the idea of looking for value everywhere. One of the ways we manage risk is to be invested in every sector. But as an active manager, we'll be overweight and underweight relative to the Russell 1000 Value Index. We are benchmark-aware, but we do place bets against that benchmark and try to outperform it.

The analysis of the downside risk when entering a position also helps to minimize risks. If you have a lot of confidence that the holding has a good return profile for the amount of risk, it is manageable if the negative scenario continues.

From a risk standpoint, we know the marginal contribution of risk of each of our holdings. We know where our tracking error is versus the benchmark, but we are not managing to a specific number. We are more interested in getting good ideas for our portfolio. 

Loomis Sayles Value Fund

FUND FACTS

Symbol	LSGIX
Website	www.loomissayles.com
Address	Loomis Sayles & Company LP One Financial Center Boston, MA 02111
Tel. No.	800-633-3330
Inception	5/13/1991

PORTFOLIO (AS OF 9/30/06)

Total Net Assets *	\$ 71.4
Avg Mkt Cap (\$ Weighted) *	N/A
Average Price/Earnings Ratio	17.2x
Average Price/Book Ratio	2.5x
Turnover Ratio	36 %

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$ 100,000
Min Subsequent Investment	\$ 50
Min Initial IRA Investment	N/A

RISK (AGAINST S&P 500 - SINCE INCEPTION)

Alpha	0.60
Beta	0.88
R-Squared	0.88
Ann Std Deviation	6.99
Sharpe Ratio	2.06

RETURNS VS. S&P 500 INDEX

	LSGIX	Index
1 Year (Cum.)	22.83 %	14.23 %
3 Year (Ann.)	18.65 %	11.82 %
5 Year (Ann.)	11.18 %	6.08 %

RETURNS VS. RUSSELL 1000 VALUE TR INDEX

	LSGIX	Index
1 Year (Cum.)	22.83 %	20.28 %
3 Year (Ann.)	18.65 %	16.54 %
5 Year (Ann.)	11.18 %	10.89 %

FEES AND EXPENSES

Max Sales Charge - Front	0.00 %
Max Sales Charge - Deferred	N/A
Max Redemption Fee	0.00 %
Total Expense Ratio (9/30/05)	0.85 %

PORTFOLIO MANAGER

Warren Koontz	Jun-2000
Arthur Barry	Jul-2005
James Carroll	Nov-2002

* millions

Data through: 11/30/06

Source: Company Documents; Lipper

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