

Confidence in Fundamentals

The Paradigm Value Fund takes advantage of inefficiencies in the small-cap market to develop a deeper understanding of target companies and, as a result, gain advantage in the marketplace. Seeking capital appreciation, portfolio manager John Walthausen is looking for stocks with strong fundamentals and long-term potential.

Q: What is the investment philosophy of your fund?

A: Our philosophy is that we are not just buying stocks, we are buying businesses. We look at companies in a comprehensive manner, understanding that you need to have leading products that the market wants, but they don't necessarily need to be innovative. The company has to have effective means of delivering value to the marketplace and possess some competitive advantage. We're building a list of companies, one company at a time.

Q: What qualities do you look for in a company?

A: We look for management that has something to work with and a proven record of success. We also look at what is changing, both in the macro environment and within the company, because change is the critical aspect which is going to drive changing security prices. We are looking at the dynamics of the situation to try and come up with conclusions that are more intelligent than other folks' conclusions in the marketplace. To derive those good conclusions, you need to engage in a lot of fundamental research; look at the company, the numbers, the product line, and the competitive situation.

The small-cap value arena is very fertile to work in. Most companies in this mar-

ket cap range are disliked or neglected. There are frequently very good reasons for this sometimes, but we believe companies which have fallen out of favor because of external factors to their industry, or internal factors to the company, or styles to the marketplace may offer opportunities. We need to try to understand situations which may not be fully understood and get an intellectual advantage over our peers.

We also find it reassuring that the academic studies do suggest that as you get deep into the small-cap end and the small-cap value stocks, the results will tend to be biased in your favor, because those stocks tend to do better than the blue chip stocks over the long term. And we have held a good number of positions throughout.

Q: Generally, those economic studies consider holding a stock for more than ten years, and very few fund managers hold stocks beyond three years.

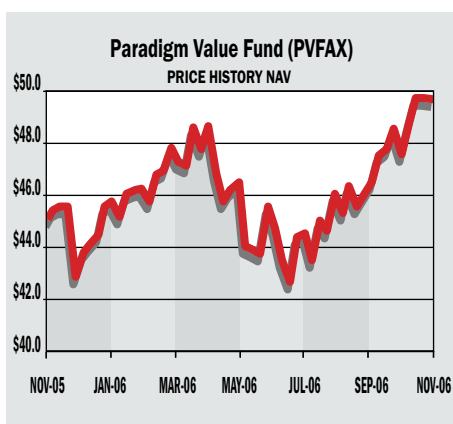
A: Our objective is to find a stock where there are real fundamentals which will carry us for the long term. And while the fund itself has only been in business just shy of four years, we have been using this process with institutional investors now for over 10 years.

Q: How is your research process organized?



JOHN WALTHAUSEN has devoted more than 30 years to researching and investing in small-capitalization companies. He has been Portfolio Manager for Paradigm Capital Management since the company's inception in 1994. Prior to that he was Senior Vice President and Director of Research for C.L. King, research analyst for First Albany, and small-cap portfolio manager for Mutual of America. He received his MBA from New York University and BA degrees from Kenyon College and City College of New York.

“We are looking for three things: valuation, a management plan that will enhance the value of the business, and indications that management can execute that plan effectively. Change is the critical thing that will drive security prices.”



A: One of the key characteristics of the small-cap value marketplace is that there are literally thousands and thousands of companies. Even if you don't go any further down than \$50 million or \$75 million, and that's where our lower cut off is in terms of the market capitalization, there are still roughly 4,000 stocks that would qualify. We have developed a number of scoring systems, rather than screens. Scoring helps you take every important aspect and rank those characteristics against all the possible stocks within the small cap arena that you might buy.

In a broad sense, we are looking at valuations, at changes in growth rates, changes in profitability, insider behavior and a sign of what the Street sentiment is. The more insiders are enthusiastic in buying their stock and the less enthusiastic the Street is, the more enthusiastic we are about the stock. It's not going to help you if the company is well sponsored by the Street but if a company does well, sooner or later the Street will find it and we'll do well on that transition.

Once we have viewed these scoring systems and found some new names to look at, then begins the process of taking apart the company financials and building historical earnings models. We want to understand the dynamics within the company, where the opportunities are, where the challenges are. We want to see what the best parts of the business and the not-so-good parts of the busi-

ness are and judge the opportunity for the management to build on the strong while reducing investment in declining businesses. So we want to understand the cash flow characteristics of the company.

We look for strong cash flows, and we want to be able to substantiate that they can self-finance their own growth. It gives us a couple of points of reassurance. One, if we are seeing good cash flow, we know it's a good business. It probably also means that whatever earnings they are showing are being conservatively accounted for. If we run across some companies that show gap earnings and don't really make any cash money, we worry. We want to see that ability to self-finance their growth, and we want to be in a position where we are not going to be diluted by their needs to go out and get additional equity financing to achieve their objectives.

Q: Can you give an example of how an idea turns into a holding?

A: K-Tron International is an example of a long-time holding. It was a very small cap when we bought it. We looked at it and we could see that there were the dynamics of a good business, and a few not-so-good businesses. A new management had come in after some mistakes of the prior management. They make equipment for the plastics industries, the pharmaceutical industries and the food industry. Their equipment meters out ingredients in larger or small quantities, but in very precise measurements. With that part of the business, they have been the leader in the industry for a long time. They also had gotten involved in some blending equipment, which is a lot less high technology. They didn't have a strong competitive position, in some parts of the feeding industry, which weren't high tech, where they were dealing with bulk products like cement and coal.

That good business had good cash flow characteristics, even though at that point

they had an extended balance sheet. We could see the new management group, that would focus on increasing returns and paying down the debt, and get on with the process of building. They paid down the debt, cleaned up some of the bad businesses, restructured how they were operating and they began the process of adding related products through product introduction, and buy some acquisitions, and gradually building the business at a very good rate with very good profitability.

Another example is a recently purchased company - Sequa Corporation. This is a company which has sales of over \$2 billion a year and trades on the NYSE, but analysts haven't covered it for a long time, even though there are some extraordinarily interesting businesses involved there. About half of their business is aerospace-related. They have a very good franchise in repairing and re-coating parts used in jet engines.

Every 2,000 hours, or so, the engines have to be taken off, inspected, and parts replaced or repaired. You can, of course, repair them at significantly less than you can replace them and for Sequa parts repair is a good profitable business. But a few years ago, the rules changed so that you could actually get into the business of making replacement parts. Replacement parts no longer had to solely come from the maker of the jet engine. But to make parts, a company had to qualify with the FAA and get the support of all the major airlines. Sequa was in a good position because they had been doing these repairs for a long time. They joint-ventured with a couple of the large airlines, most significantly with Lufthansa which is considered technically the most advanced of the major airlines, and had begun making these replacement parts as well as building their repair parts business.

On the macro side of the business, after this devastating period of so many of

the airlines going into bankruptcy, the rate of growth, the passenger miles, the people wanting to fly, is back to a 3% - 4% growth rate, which is nice consistent growth that is shown over many years. And the airlines are now being very careful about adding capacity.

So we are looking at a period of time where the airlines are going into increased profitability, but of course still being very conscious of cost, and so they are going to be better customers, and therefore people who supply them will be in a better position. And, we are in a management transition. Marty Weinstein who had been running the aerospace business has now been moved up to CEO of the company, and a number issues of getting rid of non-performing assets, restructuring the financing, getting rid of the preferred stock outstanding, cutting into some costs on the corporate overhead, are all being taken, and so you have the combination of a very profitable business growing nicely, some cost and other issues that discourage investors are being swept away by new management, and you have a favorable external environment.

Q: Are these companies based in the US?

A: Yes. K-Tron is based in southern New Jersey and Sequa is headquartered in New York City. They have operations throughout the country and globally, too. On the one hand, the global story is even good for them because more and more planes are bought in China and India and Middle East. But on the other hand, but they tend to be all serviced by the same group of suppliers, and they have done a good job in moving some of their cost lower to lower cost areas where it's appropriate.

Q: Would you like to discuss more in the research process?

A: Our research process is a fundamental process where we are diving deep

into the numbers, trying to understand the external environment and the company itself. We go back to the documents to get the real facts. We are looking for three key things - valuation, a management with a plan that will enhance the value of the business, and indications that they are executing against that plan effectively.

Q: How do you go about portfolio construction?


A: Our portfolio which is built from the bottom up, one stock at a time. We are typically running with around seventy-five names, not equally weighted. We'll weight them according to our confidence in the plan and in our ability to buy stocks at prices that we think are advantageous.

Q: Do you measure yourself against any benchmark?

A: We diversify, but we don't look specifically against a benchmark. We compare ourselves to the Russell 2000 Index but the key thing is to deliver the best tax-efficient performance for our investors over a three-year period. That's the period that we like to look at ourselves with in because we think if you try to do longer than that, then it gets a little tedious for people to look at, but if you look in a shorter period, you run the risk of having people getting distracted by the various fluctuations within the market.

But ultimately, our focus is to work in the space and try to deliver the best tax-efficient performance over the 3-year period.

Q: How do you mitigate risk?

A: We mitigate risk by diversification, by knowing the companies, and by looking at the individual risks of those holdings. We want to know whether this is a great management, a good management, or a so-so management. We look for management teams building solid companies with good cash flows. 

Paradigm Value Fund

FUND FACTS

Symbol	PVFAX
Website	www.paradigm-funds.com
Address	Paradigm Capital Management Inc Nine Elk Street Albany, NY 12207
Tel. No.	800-239-0732
Inception	1/1/2003

PORTFOLIO

Total Net Assets *	\$ 47.4
Avg Mkt Cap (\$ Weighted) *	N/A
Average Price/Earnings Ratio	N/A
Average Price/Book Ratio	N/A
Turnover Ratio	67 %

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$ 10,000
Min Subsequent Investment	\$ 100
Min Initial IRA Investment	\$ 1,000

RISK (AGAINST S&P 600 - SINCE INCEPTION)

Alpha	0.80
Beta	0.87
R-Squared	0.82
Ann Std Deviation	12.35
Sharpe Ratio	1.65

RETURNS VS. S&P 600 INDEX

	PVFAX	Index
1 Year (Cum.)	16.43 %	14.08 %
3 Year (Ann.)	24.47 %	15.67 %
5 Year (Ann.)	N/A	13.98 %

RETURNS VS. RUSSELL 2000 VALUE INDEX

	PVFAX	Index
1 Year (Cum.)	16.43 %	22.90 %
3 Year (Ann.)	24.47 %	17.91 %
5 Year (Ann.)	N/A	17.52 %

FEES AND EXPENSES

Max Sales Charge - Front	N/A
Max Sales Charge - Deferred	1.00 %
Max Redemption Fee	2.00 %
Total Expense Ratio	2.00 %

PORTFOLIO MANAGER

John B Walthausen	12/31/2002
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* millions

Data through: 11/30/06

Source: Company Documents; Lipper

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