

Focus and Discipline in the Value World

Every investor tries to buy great businesses at attractive prices, but very few of them have a clearly defined way to do this. Larry Coats, and David Carr co-managers of Oak Value Fund, believe in valuing equities as businesses and in building a thorough understanding of the key drivers of each company in the portfolio. Restricted only by the firm's investment principles and discipline, the Fund's managers may invest even at unusual value places like technology.

Q: How would you describe your investment philosophy?

A: We're value investors and for us investing means buying businesses. Our philosophy is guided by the four principles of Benjamin Graham, the father of value investing, and as a team we share these principles as the core of our operations.

The first principle is that for long-term investors the asset choice is equity. The second principle is that equities should be viewed as businesses and when valuing them, managers should apply the same process and analysis as if buying the business down the street. The basic idea is that if you can't understand the business, you can't value it. And if you can't value it, you shouldn't own it.

The third principle is to always require a margin of safety, which means to buy businesses at a discount to their intrinsic value based on the future cash flows. The fourth principle is to maintain the appropriate perspective of the market and to recognize the market as a vehicle that facilitates what we may wish to do, not as something that requires us to take any action.

I can also say that our culture is a key factor as well. We have a team of like-minded people focused on facilitating that which allows us to be the most productive and centered on making good investment decisions. Our investment committee and research group work side by side; we all bring to the table



LARRY D. COATS, JR. President & Chief Executive Officer, of Oak Value Capital Management, Inc. has over 20 years of experience in the investment business. He is President of the Oak Value Trust, serves as one of the Co-Managers of the Oak Value Fund and is a member of the firm's decision making Investment Committee.

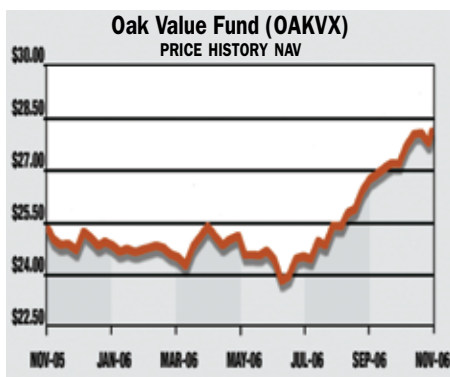
Mr. Coats also serves on the boards of several charitable organizations and the investment/finance committees thereof. He received his BS and MBA degrees in 1981 and 1983 from the University of South Carolina.



DAVID R. CARR, JR. Chairman and Chief Investment Officer, co-founded Oak Value Capital Management, Inc. in 1986 and has spent his entire professional career since that time researching companies and implementing the firm's value investment philosophy. Mr. Carr serves as one of the Co-Managers of the Oak Value Fund and is a member of the firm's decision making Investment Committee.

He has served as a director on the boards of several public company financial institutions and in board of trustee and officer positions for an SEC-registered investment company. He also serves on the investment or finance committees for several charitable organizations. Mr. Carr received his Juris Doctor degree in 1986 from the University of North Carolina (UNC) Law School in Chapel Hill and his BS in Accounting from UNC in 1982.

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everyday a strong philosophical discipline, layered with intellectual curiosity and independent thinking.

Q: What type of companies do you look for?

A: Our philosophy has three primary components – business, management, and valuation. We’re looking for good businesses that have the ability to produce predictable, growing, excess cash flows. The key point in that definition is predictability, because history has shown that a company’s ability to control its future is largely determined by its positioning relative to its customers, suppliers, competitors, and substitute products. The predictability is defined by the underlying economics of the business and its ability to perpetuate those economics into the future in an attractive manner.

Another important element is good management that is shareholder-oriented, has demonstrated an ability to run the business and to reinvest the excess cash flows into higher returning investments. The ideal businesses produce high returns on capital and do not require a lot of capital back for the core operations, and, therefore, provide the management with the ability to reinvest that excess capital for future growth.

In terms of valuation, we’re essentially trying to buy an asset worth a dollar in our estimate for 65 cents. We run discounted cash flow models and we focus on total value. We’ve learned that great businesses seldom get the valuations they deserve, but at the same time, they can become attractively priced because of the short-term nature of many of the participants in today’s marketplace.

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

A: We get paid for making decisions on behalf of Fund shareholders, so we have to be able to exercise good judgment and to bring particular experience and insight. The research process is very important as it helps you to build an understanding of the business, the factors that influence its economics, and its ability to perpetuate those economics into the future.

We evaluate the businesses based on a five-year discounted cash flow model and the challenge is having enough confidence in the inputs into the equation. So our objective is to identify the factors relevant to the company’s ability to perpetuate its competitive position and the related economics.

We have a fundamentally-driven bottom-up research process in which we don’t seek knowledge for knowledge’s sake, but we focus on the understanding of the factors that can influence a company’s ability to control its future. So our process may require visiting the company, spending time with customers, suppliers, and competitors, tracking the history of the management, or spending time with former associates to understand the way the management pursues the business.

After researching a business, we should be able to give a simple definition of the business model and its drivers. The competitive analysis and the cash flow model come together in a basic definition of the business model and its attractiveness.

We believe the forward-looking approach is important because history may be a good place to start, but our cash flow valuations are based on the future. Many value managers focus more on the past and the asset values, while we focus on the earning power of those assets as we look out into the future.

Q: Could you give us an example of ideas that turned into holdings?

A: In many cases the quantitative type of value managers use basic quantitative screens to get ideas, while the few qualitative value managers tend to wander around, talk to other value managers, or get ideas from the newspapers. We’ve taken a slightly different approach as we have created a database of

our stock universe after going through the companies in the S&P 500, Russell 1000, and Russell 2000 to identify the companies that qualify as good businesses.

We have classified the businesses based on their relative attractiveness, which has nothing to do with the valuation. That’s our starting point. At the same time we consider owning businesses with above-average rankings and attempt to understand the value of those companies. At the same time, we monitor the price activity and the valuation to recognize when opportunities arise.

For example, we bought Oracle during the first quarter of 2006 after following the stock and many technology companies for several years. In 2000 we wrote a white paper about evolving and changing business models in the technology space, and we concluded that although there were interesting business models, their valuations were not attractive. At the time, we believed there would be future opportunities to take advantage of the understanding that we were building. All of that work came to fruition in the beginning of 2006, after the shares of Oracle had been under pressure for several years.

We had continued to follow the business through those six years and we had recognized the transition in the business model. Oracle had gone from a database management software company that relied on upfront license fees to a business of integrated software solutions that includes not only databases, but also middleware and even front-end applications. Now more than 40% of the revenue comes from recurring annual license and maintenance fees, while five years ago the major source of revenue was the upfront license fee.

In terms of valuation, that means that the installed base is extremely valuable and the revenue model changed so that cash flows are realized over a period of time. That gives us a more attractive and predictable business. In addition, the acquisitions provided the ability to layer on future growth.

Finally, what you end up with is a business with margins in excess of 25% to 30% and very high returns on invested capital. We bought the stock when it was trading at about

14 times earnings, which was a phenomenal opportunity for us as a value investor.

Q: What are the guiding principles in the portfolio construction process?

A: We are typically compared to the S&P 500 from an index standpoint, but we do not construct the portfolio to mirror the index. We may have no exposure in some sectors within the index if no companies qualify as businesses able to produce predictable growing excess cash flows. For example, heavily cyclical and commodity based businesses, which have performed very well in the last couple of years, tend to not show up in our portfolio. At the same time, we don't mind overweighting certain companies or sectors.

So the portfolio is constructed with a bottom-up approach. We're buying individual companies and we tend to hold between 20 and 25 names, predominantly in the mid and large-cap space. We won't buy a business unless we can get at least 30% or 35% discount to intrinsic value based on our valuation metrics.

Because we recognize that we can't call the bottom on a name, we tend to build positions gradually. We'd buy 1% or 1.5% positions and then wait to get a better opportunity to increase that position to 3% or 4%. We usually don't buy more than 5% in a stock unless we believe that the business is very attractive, the management has done an excellent job, the valuation is particularly compelling, and we have unique understanding of the characteristics of that particular investment.

Although most of our companies are based in the US, we do have international exposure, which is an important growth driver. On average, the companies in the portfolio generate about 40% of their revenues from non-US based businesses.

Although we build the portfolio from a bottom-up standpoint, we acknowledge that we should also have at least some top-down view for risk management. Gross over-concentration in individual industries can have an adverse effect on our ability to avoid the unanticipated or unrecognized risks, and there are always such risks in the market-

place. So we make sure to be cognizant of the interactions of individual stock risk.

Q: When and for what reasons would you sell a stock?

A: We'd sell a stock for three reasons. First, if we reach a price target on a relative or absolute basis. The second reason would be a fundamental change in the business, which is a polite way of saying that we were wrong in predicting the future for this business. The third reason would be if we have a better idea. Assuming that we have an equally attractive business, we'd sell a 90-cent dollar to buy a 65-cent dollar. Most often a sale results from a combination of those factors.

Q: What kind of risks do you perceive and how do you mitigate them?

A: Most importantly, we define risk as the potential for permanent loss of capital. Our responsibility is not to eliminate risk, but to identify, understand, and price risk in order to take advantage of opportunities where the risks and the related opportunities are inappropriately priced. When we look at risk, we first look at the individual businesses. Then we look at the relations across those businesses within the portfolio. While we may have some concentration in individual industries, we're aware of the correlation between the drivers and the underlying economics.

For example, there are highly leveraged businesses, businesses dependent upon the capital markets to execute their business on a day-to-day basis, companies with regulatory or accounting issues, and companies with changing business models. Individually, none of those four components should be entirely excluded from the portfolio because, separately, those risks are manageable. However, the combination of those risks is dangerous, so we tend to look at the risks that companies share.

While most value investors would buy when a company hits their buy targets, we're also focused on understanding the risk of that investment over the future. We don't mind being early, but we don't want to be too early. On the one hand, we seldom get the opportunity to buy a great business, but on the other hand, what we really think a great business is worth, may not ever come to fruition. **T**

Oak Value Fund

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| Symbol | OAKVX |
| Website | www.oakvaluefund.com |
| Address | Oak Value Fund P.O. Box 46707 Cincinnati, OH 45246-0707 |
| Tel. No. | 800-680-4199 |
| Inception | 01/18/93 |

PORTFOLIO

| | |
|------------------------------|----------|
| Total Net Assets* (11/30/06) | \$165.8 |
| Avg Mkt Cap (\$ Weighted)* | \$26,500 |
| Average Price/Earnings Ratio | N/A |
| Average Price/Book Ratio | N/A |
| Turnover Ratio | 29% |

INVESTMENT INFORMATION

| | |
|----------------------------|---------|
| New Investment | Open |
| Min Initial Investment | \$2,500 |
| Min Subsequent Investment | \$100 |
| Min Initial IRA Investment | \$1,000 |

RISK (S&P 500)

| | |
|-------------------|-------|
| Alpha | -0.14 |
| Beta | 0.79 |
| R-Squared | 0.66 |
| Ann Std Deviation | 7.08 |
| Sharpe Ratio | 0.61 |

RETURNS VS. S&P 500 INDEX ***

| | OAKVX | Index |
|---------------|--------|--------|
| 1 Year (Cum.) | 12.45% | 14.23% |
| 3 Year (Ann.) | 7.25% | 11.82% |
| 5 Year (Ann.) | 4.59% | 6.08% |

RETURNS VS. RUSSELL 1000 GRO TR IX INDEX ***

| | OAKVX | Index |
|---------------|--------|-------|
| 1 Year (Cum.) | 12.45% | 8.36% |
| 3 Year (Ann.) | 7.25% | 7.96% |
| 5 Year (Ann.) | 4.59% | 2.58% |

FEES AND EXPENSES

| | |
|-----------------------------|-------|
| Max Sales Charge - Front | 0.00% |
| Max Sales Charge - Deferred | 0.00% |
| Max Redemption Fee ** | 2.00% |
| Total Expense Ratio | 1.29% |

PORTFOLIO MANAGER

| | |
|---------------------|----------|
| David R. Carr Jr. | Jan-1993 |
| Larry D. Coats, Jr. | Jul-2003 |

*millions **on shares held less than 3 months

***as of 11/30/06

Data through: 10/31/06

Source: Company Documents; Lipper

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