

Mid-Cap Gems

The true business owner perspective means a truly long-term view when buying and selling stocks. That in itself provides an advantage over the competition, according to Jim Norris the manager of the Wells Fargo Advantage C&B Mid Cap Value Fund. The long-term view and the relatively small number of holdings enable him to capitalize on the short-term problems and respective price dips of otherwise quality businesses.

Q: How would you describe your investment philosophy?

A: Our philosophy is based on the core belief that a stock is an ownership interest in a business. That means that stocks ought to be bought and sold with the approach of a business owner and that has certain implications for the stocks that we are choosing.

The first implication is a focus on quality and a great deal of what we do is quality assessment. The second implication is a longer-term time horizon. While the average stock on the New York Stock Exchange is held for less than a year, our average turnover is about 25%, which means that our average holding period is about four years. We analyze companies as if we're going to hold them for ten years because that's the time horizon of a business owner. The third implication is the intensive research required by that approach. We pay a lot of attention to the fundamentals and we know our companies well before buying them.

There are also implications for the valuation. A business owner wouldn't consider the price-to-earnings or the price-to-book ratio. Instead, his valuation is based on discounted cash flow and we believe that's how you ought to value stocks. We use a 10-year discounted cash flow model to calculate the intrinsic value of the business, and we aim to buy the stock at a discount of at least 40% to that intrinsic value.



JAMES R. NORRIS is a Partner with Cooke & Bieler. He earned a bachelor of science degree in Management from Guilford College graduating with high honors, first in his class. Mr. Norris received his M.B.A. from the University of North Carolina at Chapel Hill where he graduated in the top 5% of his class and was a recipient of the Dean's Scholar Award.

Following graduate school, he spent nearly 10 years with Sterling Capital Management as Senior Vice President of Equity Portfolio Management before joining Cooke & Bieler in 1998.

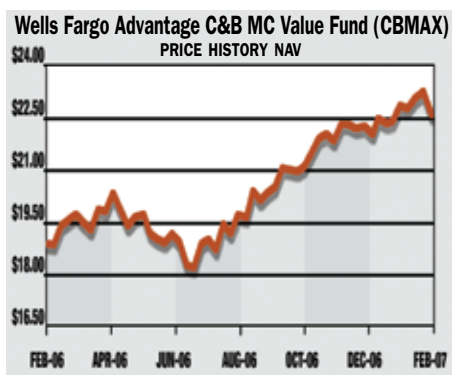


MICHAEL M. MEYER is a CFA and Partner with Cooke & Bieler. He graduated from Davidson College cum laude in 1987 with distinction in Economics, where he was also a member and captain of the varsity tennis team.

After working four years for Sterling Capital Management as an equity analyst and head equity trader, Mr. Meyer attended The Wharton School of Business graduating with an M.B.A. degree in Finance in 1993.

He joined Cooke & Bieler in 1993.

“While Wall Street defines risk as volatility, we perceive risk as the probability of loss. As a result, we focus on higher quality companies with solid fundamentals and a low risk of operating problems because that minimizes the risk of portfolio problems.”



An important differentiator of our philosophy is our perception of risk. We perceive risk as the probability of loss. As a result, we minimize the risk by paying close attention to the quality of the businesses that we're investing in. We focus on higher quality companies with solid fundamentals and a low risk of operating problems because that also minimizes the risk of portfolio problems. That means that we don't mind buying volatile stocks and we are willing to take benchmark risks. We just avoid businesses with a high probability of loss.

Q: Why do you believe that the mid-cap space is worth investing in? What's your definition of the mid-cap universe?

A: Historically, our company has been a large-cap stocks manager. We moved down the capitalization spectrum applying exactly the same philosophy because the mid-cap space enhances our return potential without unduly increasing the risk. The idea is that the further we move down the capitalization spectrum, the more companies there are to choose from, and the greater the chance to add value for our clients. So I believe that the mid-cap space represents the best of both worlds as it offers greater return potential than the large-caps with less risk than the small-caps.

We define the mid-cap space in the range between \$500 million to \$5 billion. That range is a little bit lower than the range used by most funds, which usually is between \$1 billion and \$10 billion. But we operate at the lower end of the mid-cap spectrum on purpose - there are more companies in the lower range and a greater chance to add value. Overall, I believe that there are about 1,500 companies in our investment universe.

Q: Would you explain your definition of quality?

A: We have defined quality with three bullet points that we call 'the three Cs of investing.' They are Competitive Advantage, Cash Flow, and Conservative Balance Sheets, again from the business owner's perspective. If your business doesn't have an advantage against competition, then it is doomed for mediocrity, and we don't want mediocre businesses.

The focus in cash flow has kept us out of a lot of trouble over the years. It kept us out of the 'dot com' mania, for example. In certain periods the market gets speculative and companies with questionable business models are driven to high valuations. But we are never tempted by those companies because of our focus on cash flow. The established history of cash flow is important to us because we need to project the cash flows years into the future, and history gives us some confidence in the forecast.

The emphasis on conservative balance sheets has also been important for avoiding the big disasters of the last few years. Tyco, Global Crossing, and Enron had one thing in common - they had too much debt, which exacerbates the problems. More importantly, the balance sheet provides a good insight on how the company is managed. Since we don't manage the business ourselves, we want to make sure that it is run conservatively.

The three 'C's' form the basis of the type of companies we're looking for. Of course, there is no such thing as the perfect stock because the fourth variable is the valuation. It is extremely difficult to find stocks that score perfectly on competitive advantage, cash flow, conservative balance sheet, and have attractive valuations. There are trade-offs to be made and my job as an analyst is to assess those trade-offs.

Q: What's your strategy for finding high-quality companies trading at a discount?

A: There's a misconception that growth managers own the good companies and value managers cannot focus on quality. We have found that that is not the case, certainly not in the way we define value. We are

able to buy high quality companies at good prices mainly because we have a different time horizon than the Street. Even the best companies occasionally disappoint and then the Street punishes them too severely. The investor who sells the high-quality company is making an assessment about the next year or the next quarter, not about the long term, and that gives us an advantage.

The result of that strategy is that we're usually buying companies under a cloud of uncertainty. We know that we are buying a quality business, which disappointed the Street in some way. We spend a lot of time in research trying to assure ourselves that the problems are temporary and fixable, and we are willing to buy in the face of those problems before they're solved. It's a bit of a contrarian approach but we buy only companies that meet our requirements for quality.

Q: What are the milestones of your portfolio construction process?

A: We manage a concentrated portfolio with 30 to 50 stocks at any given time. The weightings in the individual industries and sectors tend to be rather different from the index. Our weight in an industry can be zero, double, or triple, depending on our conviction level in the companies and our assessment of risks.

Although we are benchmark aware, we are not benchmark driven. Many mutual funds in this business follow the index closely and are scared to stray too far from it. But since we go to great lengths to minimize the business risk, we're not afraid differ from the index. That means that in a speculative environment when the market is going up driven by a narrow group of stocks, we'll probably underperform.

Q: Would you highlight your research process?

A: It is a bottom-up process where our assessment is driven by the competitive advantage and the 10-year outlook. We don't try to come up with the next quarter's estimate because everyone on Wall Street is doing that and their estimate's just as good as ours. So we're trying to assess the next 10 years and to not be distracted by the noise for the current quarter.

In the old days this business was driven by getting better information sooner than the rest of the Street. Investors would spend a lot of time trying to uncover some tidbit of information that no one else knew. But those days are gone and we don't even structure our research process to gain an information advantage. Rather, it's about seeking judgment advantage.

Today you win the investment game by making better judgments on the data that's available to everyone. We believe that the 10-year outlook provides an advantage over the short-term outlook of most investors. Also, we are very thoughtful and we don't make too many decisions. With 40 stocks on average and turnover of 25%, there are only 8 new stock ideas we can put to work in our portfolio every year, which is a manageable number. For comparison, many fund managers have to come up with 100 new ideas per year and don't have the time to analyze the situation completely. Our approach enables us to be more thorough in our research and gives us the confidence to take bigger position sizes.

Q: Could you give us some examples of stock picks that illustrate your process?

A: Corinthian Colleges is our most recent purchase and is a good example of what we look for. It is the third largest player in the for-profit segment of the post-secondary education market. The company has a very capital efficient business model. In fact, it has the rare advantage of negative working capital because tuitions are paid in advance. That means that the company is not constrained when it grows the business. The second point is that there are barriers to entry. It takes years to get accreditation and to qualify for government-backed student loans, which are very important in this business. This particular company also has a pristine balance sheet with more cash than debt. The business has a history of strong profitability and because of this combination, we like the business model for the long-term.

Currently the stock is cheap because there is a cloud of uncertainty hanging over it. The entire industry got a bit anxious to grow, including Corinthian. They over-expanded and


built too many schools. At the same time, some of these companies lost their focus and got into regulatory trouble on a few issues. As a result of the negative publicity, enrollments slowed down right when new capacity was coming online. So the earnings got hurt and Corinthian's operating margins tumbled down from more than 20% to about 6%.

But we're buying the stock because our analysis suggests that they have turned the corner operationally. They have rationalized some of their capacity and their marketing costs have started to decrease. This is a good enough business and we have a high degree of confidence that if the problems are solved, the future of the company is bright. It has a debt-free balance sheet and solid cash flow, so we get paid while we wait.

Q: What are the risk management techniques that you use?

A: First and foremost we insist on quality because if you're only buying quality businesses, you've already gone a long way in managing your risk. We also manage risk by constantly reviewing the companies in the portfolio. It is a dynamic world and things do change. Once we have analyzed a company and made a 10-year forecast, we don't want to forget about it for 10 years because sometimes forecasts are wrong, and sometimes businesses and environments change. So we re-evaluate and review every thesis quarterly.

We also have some risk control measures that we implement in the portfolio construction stage. We limit the position sizes in the portfolio to 5%. Our industry exposure is limited to 20%, while our sector exposure can be no more than one-third of the portfolio. That's how we manage risk and we make sure that we are well diversified.

Another thing that differentiates us from other fund managers is the experience in managing money. The company has been doing this for 57 years and there aren't many companies in this industry that have been around that long. The longevity by itself says something about our process because an approach that doesn't work wouldn't survive for more than 50 years. 

Wells Fargo Advantage C&B Mid Cap Value Fund

Symbol	CBMAX
Website	www.wellsfargoadvantagefunds.com
Address	Wells Fargo Funds Management LLC 525 Market Street, 12th Floor San Francisco, CA 94105
Tel. No.	800-222-8222
Inception	02/18/98

PORTFOLIO	
Total Net Assets*	\$780.7
Avg Mkt Cap (\$ Weighted)*	\$3,800
Average Price/Earnings Ratio	23.92x
Average Price/Book Ratio	3.11x
Turnover Ratio	39%

INVESTMENT INFORMATION	
New Investment	Open
Min Initial Investment	\$1,000
Min Subsequent Investment	\$100
Min Initial IRA Investment	\$250

RISK (AGAINST S&P 500 - 3 YEARS)	
Alpha	2.54
Beta	1.32
R-Squared	74
Ann. Std Deviation	10.85
Sharpe Ratio	0.91

RETURNS VS. LIPPER MID-CAP VALUE FUNDS AVG		
	CBMAX	Index
1 Year (Cum.)	20.21%	14.80%
3 Year (Ann.)	13.34%	14.24%
5 Year (Ann.)	13.08%	13.49%

RETURNS VS. RUSSELL MIDCAP VALUE INDEX		
	CBMAX	Index
1 Year (Cum.)	20.21%	18.36%
3 Year (Ann.)	13.34%	18.21%
5 Year (Ann.)	13.08%	16.12%

FEES AND EXPENSES	
Max Sales Charge - Front**	5.75%
Max Sales Charge - Deferred	1.00%
Max Redemption Fee	0.00%
Total Expense Ratio	1.38%

PORTFOLIO MANAGER	
Jim Norris	02-Feb-98
Mike Meyer	02-Feb-98

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

Data through: 02/28/07

Source: Company Documents; Lipper

Ticker staff searches for mutual funds for their consistency in performance and durability of investment style.

Our interview covers investment philosophy and strategy, research process, portfolio construction and risk control for funds. Through an interview we uncover long-term strategies and processes that help to generate long-term returns.

You can read more on this and other funds at **Ticker.com**