

## Active for Alpha

*Jerome Heppelmann, the manager of the Old Mutual Focused Fund, believes that there is ample opportunity in the large-cap space because most of his peers strictly follow the benchmark. Contrary to them, the fund invests in no more than 30 companies. Cognizant of the inherent risk in a focused portfolio, the manager grounds his selection on the trade-off between valuation and growth and looks for companies that offer downside protection.*

**Q: How would you describe your investment philosophy?**

**A:** The Focused Fund is managed with the belief that our clients deserve to have an active manager and better returns than those of a passive index fund. We believe that there is ample opportunity in large-cap core because the majority of the large-cap core funds do not offer much differentiation as they tend to follow the benchmark in terms of sector and securities weight. We invest in no more than thirty holdings with the idea to add as much alpha as possible while controlling the risk.

Going down to the portfolio level, there are two parts of our philosophy. First, we believe that every holding should offer an appropriate trade-off between valuation, near-term dynamics, and long-term growth. That approach differentiates us from many fund managers because deep-value managers are usually focused strictly on valuation, while growth managers just focus on growth. For us, every holding needs to be considered in all the three areas.

The second part of our philosophy is that the best way to analyze companies is through both quantitative and fundamental analysis. We think that both of them are absolutely necessary for every holding in the portfolio. Overall, we believe that growth is a function of value and our philosophy is to balance the growth with the cost that we have to pay for it, and to analyze that relationship both quantitatively and fundamentally.

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

**A:** We start by making sure that we're in the right market capitalization range. The second part of our process is the quantitative part, where we screen for the characteristics that we consider important for future stock price appreciation. With our custom quantitative screens, we look at three broad areas - valuation, near-term investment dynamics and long-term growth, but we make sure that we're looking at the right quantitative measure.

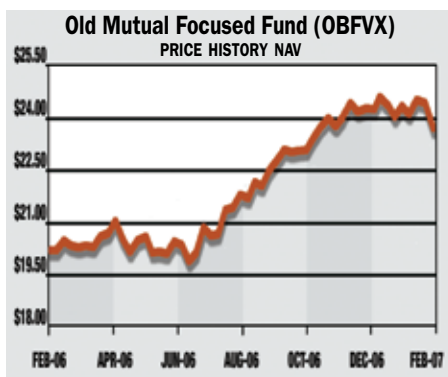
For instance, for the valuation of software companies we may be using the Price/Sales ratio, not Price/Earnings. A cable company may have huge capital spending due to investments in digital technology, and it may not be showing earnings growth at the moment. For such companies the traditional P/E valuation also is not the best measure. So our process is designed to focus on the characteristics appropriate for a given company.

The quantitative step also represents an opportunity to compare the companies that we own to peers with similar operating characteristics. It is an opportunity to take a deeper look at the quality of earnings from the quantitative side; to evaluate if the earnings, the cash flow stream, and the revenues follow each other in a nice linear fashion. That characteristic has always been a helpful predictor of the earnings quality because it allows you to avoid companies like Tyco in the late 90's



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Prior to joining Liberty Ridge Capital, Mr. Heppelmann was a member of the Investment Advisory Group within SEI Investments servicing investment management clients. He holds a BA with a concentration in Finance from The University of Notre Dame. Mr. Heppelmann holds the Chartered Financial Analyst designation and is a member of the CFA Society of Philadelphia.



that used a lot of debt to purchase top-line revenue growth.

The next step, the fundamental analysis, again focuses on the three general areas. We don't apply strict rules for the P/E ratio or the earnings growth; to us it's all about the trade off. If the company is growing slowly but has delivered predictable top-line and bottom-line cash flow growth in the past, we may pay more for this company. We'll also examine the barriers to entry and the business model, and we prefer businesses where every new dollar of growth offers slightly higher margin.

For example, we like the oligopolies that are able to deliver strong and growing free cash flow. The management teams should have a good track record and be motivated to focus on returning cash to the shareholders and growing the free cash flow; they shouldn't just focus on revenue growth. Typically, in an oligopoly we would own the number one or two players while remaining sensitive to valuations. That's easier now because there are many indus-

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try leaders with rich valuation, while the second-best company that may offer more potential for future growth is trading at attractive valuation.

Essentially, in the fundamental part of the process we're looking for the right valuation, making sure that we apply the appropriate metrics for each industry. We prefer companies with strong near-term dynamics, but sometimes we'll own companies with weak near-dynamics if the valuation is compelling and you can wait for the investors to change their extremely negative view on the company.

**Q: Could you describe your fundamental criteria in more detail?**

**A:** Overall, we use the fundamental analysis to examine companies, industries, sectors, and the operating models. We look for oligopolies, for companies with strong free cash flow, and with balance sheets that enable them to leverage the operating model across other industries, verticals, or products. When examining the quality of earnings on the fundamental side, we may look at customer concentration. Often a mid-sized company may say that it has landed Wal-Mart or Home Depot as a customer, and we'll review how their revenue is distributed. If the new client accounts for 30% of the revenue, the company will probably need to expand its production or warehouse base to meet the extra demand, and that will slash a lot of the margin potential right away.

So the quality of earnings is related to the customers. Large customers like Wal-Mart and Home Depot may have too much control over the company. They'll also demand lower prices each year, so the company has to be able to cut costs. The state government and the federal government are pretty hard to get and are risky customers as many things can go wrong.

**Q: Would you give us examples of specific stock picks that illustrate your research process?**

**A:** Nokia in 2003 is a wonderful example of a company that fit everything we look for. Its market share in the world cell phone market is more than 40%, and it leads this market by a large margin. It typi-

cally has twice the sales of the number two company, which right now is Motorola. Several years ago the stock went down to \$11 because they couldn't get a prototype right. That was a great opportunity for us because companies with such market share have tremendous cost advantage. They can take time to get the prototype right because when they do, they will produce it cheaper than everyone else.

At that time the company had about \$3 cash per share and was trading for about 10 times earnings. Since it was the market leader in a fast-growing industry with few players, and since it had competitive advantage in terms of operations, the price drop represented an excellent opportunity for us. Cell phones will still go through improvement and upgrades in the next years, so the long-term growth is still there.

About a year after we bought Nokia, Motorola managed to take share. Nokia slashed its prices and demonstrated that it could win a price war. Motorola quickly realized that it couldn't beat Nokia and prices went back up nicely. Their market shares didn't change, which proves why it is worth buying companies in that type of competitive position.

Other examples include Microsoft, which has been my top holding for a couple of years. I believe that it is an oligopoly story that exhibits everything we look for in terms of cash flow, valuation, balance sheet, barriers to entry, new products, etc.

CVS had been another large holding not only because of its oligopoly in drug retail with Walgreen, but also because of the huge discount in valuation relative to Walgreen. In terms of locations, CVS actually now is the largest drug store company, but it usually doesn't get the credit it deserves because it is difficult to stand out with a competitor like Walgreen. While Walgreen undoubtedly is the favorite among investors, I'm not sure that it deserves the high premium in the P/E against CVS. We became very interested in CVS a couple of years ago as we calculated the earnings opportunity they had from integrating and

fixing the Eckard stores they bought in Florida and Texas.

**Q: What general rules do you follow in your portfolio construction process?**

**A:** It is a concentrated portfolio and we typically want to be able to own positions of at least 4%. With such large positions, we need to balance the downside risk. We attempt to mitigate downside risk by owning industry leaders, companies with free cash flow and solid balance sheets. Even if the market pulls back, such companies usually hold up well. So our stock selection includes an analysis not only of the upside potential, but also of the downside risk in the case of market, industry, or company problems.

I believe that our shareholders recognize that in a concentrated portfolio there is inherent risk, and if a company goes down like Microsoft did, we'll add to it. As it goes down more without the fundamentals deteriorating, or if the company executes in accordance with our expectations, we'll continue to add to our position. So we typically start with the minimum position weight of 4% and then add on weaknesses.

**Q: How many stocks do you typically hold?**

**A:** We hold no more than 30 stocks; the average is probably about 26 or 27 names. We don't necessarily drive for huge diversification but I do want exposure to the top five or six S&P sectors. I don't want to manage a fund where all the names are in energy or technology. Although our process is bottom-up in looking for the best companies in terms of valuation, near term dynamics, long term growth, we do have some diversification. I don't run a sector fund and I apply our criteria to healthcare, technology, energy, consumer staples, etc.

**Q: What events would prompt a sell decision?**

**A:** As the stock goes up and the valuation becomes less compelling, we'll constantly trim on the strength. If the company is priced for perfection, we don't want to own it even if we're happy with the company. Likewise, if there is a change in the


fundamentals that isn't reflected in the valuation, we would probably take advantage of that change.

Sometimes in the course of our research process we'll find another company with very compelling valuation, and to include it in the portfolio we would move something out. So the portfolio changes constantly reflect our updated view of the best companies in terms of the trade off between the three major areas.

**Q: What risks do you perceive and how do you handle them?**

**A:** We recognize that there is more company risk in a focused portfolio and we try to mitigate it in a few ways. One of the risk controls is maintaining exposure to the major sectors. I am fully invested and typically wouldn't hold more than 4% in cash. I take out the market-cap risk by a set of market caps that correlates with my benchmark, the S&P 500 index, because I want the process to be all about stock selection.

On an individual company basis, the trade off between valuation, near-term dynamics and long-term growth is a great way to start mitigating the risk because of the valuation backup. Often these companies offer good yields as well. GE, for example, right now has yield rate of 3%. If the stock drops too much, the yield goes up considerably.

The other part is analyzing the downside risk for each security - how would the company behave in a down market and what protection do we have on the downside. But I don't have hard rules to sell a stock if the company goes down by a certain percentage. As in my favorite example, when Microsoft went down about 15%, I was buying a lot more because of the conviction. In a slowing economy the oligopolies turn out moderate growth but huge free cash flow. Microsoft returned almost \$100 billion to shareholders through stock buybacks, special dividends, dutch tenders and regular dividends over the past 5 years and generates enough free cash flow to slowly take the company private, if necessary. 

## Old Mutual Focused Fund

Symbol	<b>OBFVX</b>
Website	<a href="http://www.oldmutual.com">www.oldmutual.com</a>
Address	Old Mutual Capital Inc 4643 South Ulster Street 6th Floor, Denver, CO 80237
Tel. No.	800-433-0051
Inception	2/12/1999

### PORTFOLIO

Total Net Assets*	\$27.5
Avg Mkt Cap (\$ Weighted)*	\$101,200
Average Price/Earnings Ratio	22.21x
Average Price/Book Ratio	4.27x
Turnover Ratio	90.9%

### INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$2,500
Min Subsequent Investment	\$0.00
Min Initial IRA Investment	\$2,000

### RISK (AGAINST S&P 500 DAILY REINV IX - 3 YEARS)

Alpha	0.13
Beta	0.99
R-Squared	0.74
Ann. Std Deviation	8.11
Sharpe Ratio	0.90

### RETURNS VS. RUSSELL 3000 INDEX

	OBFVX	Index
1 Year (Cum.)	17.42%	12.03%
3 Year (Ann.)	10.73%	10.02%
5 Year (Ann.)	7.96%	7.93%

### RETURNS VS. S&P 500 DAILY REINV INDEX

	OBFVX	Index
1 Year (Cum.)	17.42%	11.97%
3 Year (Ann.)	10.73%	9.10%
5 Year (Ann.)	7.96%	6.82%

### FEES AND EXPENSES

Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	1.00%
Max Redemption Fee**	2.00%
Total Expense Ratio	1.15%

### PORTFOLIO MANAGER

Jerome Heppelmann	12/12/1999
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\*millions

\*\*for purchases made in the last 10 calendar days

Data through: 02/28/07

Source: Company Documents; Lipper

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