

## The Patient Investor

*Taking advantage of Wall Street's focus on the short term, Ariel Appreciation Fund seeks stocks that are temporarily out of favor but whose long-term potential and predictable business models offer shareholders great value over time. Portfolio Manager Matt Sauer invests in quality companies in industries where Ariel has expertise, and only buys when these businesses are selling at a significant discount to their private market value.*

**Q: What is your investment philosophy?**

**A:** I would say, we are patient investors and independent thinkers. We believe in finding value in stocks by doing our own independent research. By concentrating on the long-term, our patient approach allows us to take advantage of buying opportunities that frequently arise from Wall Street's excessive focus on the short-term. Just like the fabled tortoise, the symbol of our firm, we value patience and persistence over the fleeting and the flashing. We are also contrarians. We operate under the premise that financial success is achieved not by chasing the crowd, but seeing what others have missed.

We sum up our investment approach and evaluation of companies, by what we call QEV – *Quality, Expertise and Value*. We believe that a company should be very high *Quality* (in terms of its leadership, its brand franchise, balance sheet and business fundamentals.) We invest only in our circle of competence – meaning in industries we know extraordinarily well, where we have proven *Expertise*. And we believe a company should be of good *Value* when we buy it. As patient investors, we always have our sights set on the long term because in many cases we

are buying stocks that are out of favor with the marketplace and it can take some time for the valuation to catch back up.

We have a concentrated portfolio so we get to know our holdings exceedingly well and understand the businesses they are in. We like to say we are trying to know more and more about less and less. We calculate a company's value on a private market value basis and on a cash flow basis, so we are buying the equities at a discount. We are basically looking for a 40% discount to our estimate of private market value.

**Q: How many stocks do you monitor?**

**A:** We have a watch list of companies that we would like to own at a certain price and we continually monitor this group. The universe of stocks we follow is approximately 400. Then, when events conspire against one of these quality names, we determine if we are going to buy. We own about 80 stocks across all funds. In Ariel Appreciation Fund we have about 35 stocks, so the fund is fairly concentrated.

**Q: How do you go about building your investment strategy?**

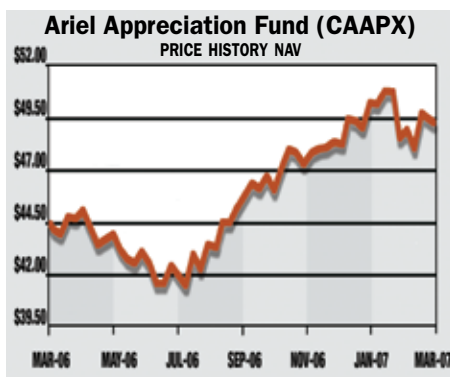
**A:** Our investment approach can be de-



**MATTHEW F. SAUER** Senior Vice President, is Portfolio Manager for Ariel Appreciation Fund, a mid-cap value mutual fund. In this capacity, he works side-by-side with John W. Rogers, Jr., Ariel Appreciation Fund's Lead Portfolio Manager.

Additionally, Matt specializes in the insurance industry. He joined Ariel in 2006 with more than 18 years of experience in the investment management arena. He spent 13 years with Oak Value Capital Management in a variety of leadership positions culminating in his roles of Executive Vice President and Senior Portfolio Manager as well as Director of Research. While at Oak Value Capital Management, Matt was instrumental in the launch and management of the well-respected Oak Value Fund.

Matt earned his MBA from Duke University and graduated from Lawrence Technological University with a BS in Humanities.



scribed as bottom up. We do not necessarily look at a benchmark or try to get within any kind of specific percentage of the benchmark. We simply look for quality businesses that we understand and think are attractive and more importantly, will reward patient investors.

**Q: Could you describe two or three industries that you have historically invested in?**

**A:** The asset management business is interesting because a lot of value managers don't own it and so there is a long-term bias on Wall Street that "it hates itself." We have been able to own pieces of businesses from T. Rowe Price and Franklin Resources that have successful long-term track records. They have significant operating margins now and they continue to grow.

Another recent phenomenon is outsourcing which we have participated

**"Ariel manages money with one mission in mind—patience. Its approach to investing can be defined by three letters, 'QEV' – meaning Ariel believes a company should be of high Quality, within its sphere of Expertise and selling at an excellent Value when Ariel decides to buy it."**

in through a number of holdings like Accenture and Pitney Bowes. We like companies that help other companies become more efficient and stay focused on their sweet spots. We bought Accenture when tech stocks fell out of favor and we continue to own it and believe in its future.

Accenture and Hewitt (both Ariel Appreciation Fund holdings), as well as companies we don't own, like an Infosys with corporate headquarters in India, are all examples of active, successful companies in the outsourcing area. We believe it's probably a trend that will continue to grow as companies in the U.S. and across the globe look for what their core competencies are and outsource functions that they are not fundamentally set to do.

**Q: How do you generate ideas and then how do you turn an idea into a holding?**

**A:** Our investment process mirrors our mascot, Aesop's fabled turtle and theme that "Slow and steady wins the race." We have a list of only about 400 companies that we have done exhaustive research on and we have come to the conclusion that all the businesses are quality businesses. We watch and patiently wait until they become attractively valued.

Being a value investor, we know that having a longer time horizon than Wall Street, can be a big advantage. We are looking to hold a company for three to five years compared to the traditional trading mentality with a horizon of three to four months. We are event driven and we monitor the news and the changes of the business dynamics of the companies we like to invest in for the long term. We create a two-page report for our investment meetings, and as appropriate, we will prepare a full-length report, make phone calls and revise business and investment models. Our Investment Committee discusses

stocks and events surrounding the current market environment, and the entire process can take up to 30 days. We would then have an Investment Committee meeting to discuss the investment merits of the company.

**Q: Are you looking for a catalyst before you buy a stock?**

**A:** We do not necessarily decide that there has to be a catalyst in the next 3 to 6 months which may be getting back to the shorter time horizon of some investors on Wall Street. If we know that the value is going to be out over time we are more comfortable there than trying to predict a catalyst, whether it be a new contract or new product launch.

**Q: What do you do when things don't turn out as planned? When do you decide to exit a position?**

**A:** Our sell strategy is as disciplined as our approach to buying a company. We exit a name when the company's stock reaches our estimate of private market value, when there is a change in the company's strategic direction or when we lose faith in the management or the business. The business fundamentals have to change for us to say that the business is now worth less. What we do not like to do is exit because the stock price is down but we have to continually make sure that our original thesis is intact.

**Q: Could you give us one or two examples of historical stock picks that went through your research process?**

**A:** Last year we bought Aflac, a leading provider of supplemental health and life insurance products. The well-known insurance brand is expected to generate over \$15 billion in revenue this year, two-thirds of which will be in Japan. The duration in the Japanese market of the book of business is so long that new sales make up only a fraction of the cash flow of that large book of business. That is different

from the business in the United States where you have persistency of about 75%, whereas in Japan the persistency is near the 95% level.

When you analyze the trends in Japan and the U.S., the new business in Japan is a smaller portion of the current book of the business than in the U.S. And, we were able to look past the fact that Japanese sales are off of Wall Street's expectations. We reviewed our investment models including revenue and cash flow growth and we decided to buy the stock in the fall of 2006.

Another holding we have is City National Bank in Los Angeles, California. They have a stable franchise in wealth management and a great trust business. When the stock was sold off a couple of years ago, we took a closer look at the business, we talked to a few clients, competitors and area business leaders, and concluded that they had a strong and growing customer franchise in the region. This met our long-term business fundamentals criteria and we purchased the stock in May 2006.

**Q: How do you go about building positions?**

**A:** We build positions slowly. Since we have a concentrated portfolio, we add positions patiently and build our target positions. Our portfolios usually reflect more seasoned stocks that have gone up in heavier weightings more than buying a large weighting in a new stock.

**Q: Generally, what is the turnover of the fund?**

**A:** Turnover rates for all of the Ariel Mutual Funds tend to be low. The average turnover rate for Ariel Appreciation Fund over the past five years has been around 23%. Obviously, that number fluctuates based on valuations in the marketplace, the recent phenomena of private equity as well as the current number of company buyouts.

**Q: As a value investor what sectors do you avoid and what benchmark do you follow?**


**A:** We are not concerned about benchmarks when we are building portfolios. Additionally, there are industries we have not invested in because they do not necessarily fit the QEV principle that we follow.

We avoid commodity-based sectors, whether they are materials, energy, and agricultural products. We also avoid certain sectors of technology which are of very competitive nature. We do not want to be involved in companies with product cycles shorter than eighteen months. These short cycles create significant revenue and earnings uncertainty. The volatility and unpredictability in the business model do not suit our long-term investment thinking. So we do not invest in some sectors as compared to a constructed benchmark.

**Q: What kinds of risks do you monitor and what do you generally do to mitigate them?**

**A:** We diversify our portfolio across several sectors so we do have sector awareness but if there is a sector that is out of favor we certainly want to make sure that it is in our portfolio.

We do have risk awareness on stocks. We really worry about their impairment of capital; we have balance sheet measures as far as debt ratios and interest coverage ratios in order to make sure that we do not get into a situation where a temporary operating problem turns into an impairment of capital. And that is the risk that we worry about.

Our hurdle rate of 40%, stocks that are trading cheaper than our estimate of private market value serves as our best risk control measure. The classic Benjamin Graham margin of safety has served us well. 

## Ariel Appreciation Fund

Symbol	<b>CAAPX</b>
Website	<a href="http://www.arielmotualfunds.com">www.arielmotualfunds.com</a>
Address	Ariel Capital Management, LLC 200 East Randolph Drive Suite 2900 Chicago, IL 60601
Tel. No.	800-292-7435
Inception	12/01/1989

**PORTFOLIO**

Total Net Assets*	\$2,700
Avg Mkt Cap (\$ Weighted)*	\$9,740
Average Price/Earnings Ratio	N/A
Average Price/Book Ratio	2.82
Turnover Ratio	24.1%

**INVESTMENT INFORMATION**

New Investment	Open
Min Initial Investment	\$1,000
Min Subsequent Investment	\$50
Min Initial IRA Investment	\$250

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

Alpha	-0.16
Beta	1.04
R-Squared	0.80
Ann. Std Deviation	7.96
Sharpe Ratio	0.62

**RETURNS VS. S&P 500 INDEX**

	CAAPX	Index
1 Year (Cum.)	11.01%	11.83%
3 Year (Ann.)	8.27%	10.04%
5 Year (Ann.)	7.32%	6.27%
10 Year (Ann.)	13.01%	8.20%

**RETURNS VS. RUSSELL MIDCAP® VALUE INDEX**

	CAAPX	Index
1 Year (Cum.)	11.01%	17.13%
3 Year (Ann.)	8.27%	18.58%
5 Year (Ann.)	7.32%	15.22%
10 Year (Ann.)	13.01%	14.00%

**FEES AND EXPENSES**

Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	1.00%
Max Redemption Fee	0.00%
Total Expense Ratio	1.16%

**PORTFOLIO MANAGERS**

John W. Rogers, Jr. - Lead Portfolio Manager
Matthew F. Sauer - Portfolio Manager

\*millions

Data through: 03/31/07

Source: Company Documents; Lipper

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