

Capturing Performance Shifts

Over time active managers have a very difficult time beating the benchmark as they do poor cash timing, they have poor sector bets and they overweight the stocks too much. What the PathMaster Domestic Equity Fund manager Rich O'Hara is trying to do is capture the size and the style shifts of the market and not individual stocks. The Fund maintains a well-diversified portfolio primarily of ETFs which helps reduce the risk of picking the wrong stocks.

Q: What is the investment philosophy of the fund?

A: The PathMaster Domestic Equity Fund is a fund of funds. Our core belief is that over time size and style segments of the market have predictable and persistent performance trends.

We also believe that over time active managers have a very difficult time beating the benchmark. Even a large-cap growth manager has a hard time beating the Russell Large Cap Growth Index or the S&P 500 Growth Index for three reasons - poor cash timing, poor sector bets and consistent overweight in favorite stocks.

So what we are trying to do is identify the size and style segments that are likely to outperform and not try to add value by saying when the individual stocks that make up those segments will outperform or underperform. The portfolio will tilt toward value and smaller caps over the long-term.

Q: How do you go about selection?

A: We are purely quantitatively driven.

We have identified 45 factors that are captured on a monthly basis that help us identify these shifts among size and style boxes. These range from fundamental and valuation factors to technical factors.

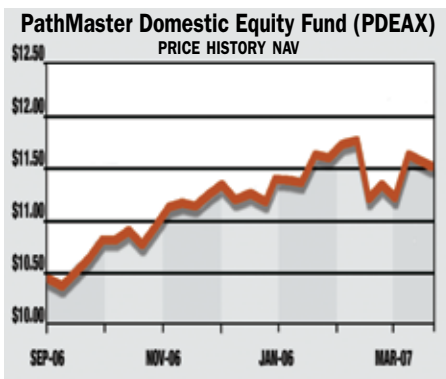
In our fact testing we look at 359 factors. Then, from a statistical regression analysis over a 20-year period of looking at data we have identified these 45 factors that we update every month. We are always looking for existing factors that are fading or decaying or new factors with more predictive power coming in. It's an evolutionary process of how you modify the model going forward. It took us over 2 years to get comfortable with these factors.

The crucial fundamental factors we look for are things like one-year change in operating profit margins of companies, net debt ratio, valuation with the market and debt asset to price ratio. On the technical factors we look for shorter-term factors like short interest ratio and money flow ratio.



RICH C. O'HARA joined Wayne Hummer Asset Management in 2003. During this time O'Hara has overseen the firm's research efforts. In addition he is the co-creator and portfolio manager of the firm's innovative Tactical Size/Style Allocation product as well as the firm's PathMaster Domestic Equity mutual fund. Previous to this, O'Hara was a research analyst from 1998 to 2003 for Lake Forest Capital, an asset management firm acquired by Wayne Hummer in 2003.

O'Hara holds a B.S. with Distinction in accounting from Pennsylvania State University and an MBA with Distinction from New York University. He is currently pursuing a B.S. in Mathematics at Northwestern University. Rich is a member of the Association of Investment Management Research (AIMR), the Investment Analyst Society of Chicago and the Chicago Quantitative Alliance.



Q: How is your investment process organized?

A: Essentially every month we run our model and we change the allocations among the six Russell iShares that we own in the mutual fund. The model determines which segment we like or don't like and we adjust accordingly.

On the first business day of every month we capture all the data for the factors that we look for and update our database and the model of the overlooking forecast for the changes.

The benchmark index for this fund is the Russell 3000 Index. Our model currently underweights the large-cap growth sector and overweights the small-cap and mid-cap value sectors. One of the reasons it underweights the large-cap sector is that despite a strong earnings season, earnings are

“Our core belief is that over time size and style segments of the market have predictable and persistent trends in market performance. What we are trying to do is capture the size and the style shifts and not bet on individual stocks.”

decelerating in the sector when you look at all the statistics. So that's a negative signal. That actually helped the model last month because if you looked at the performance of the segment the performance numbers were generated in the mid-cap area.

Q: What makes your approach to money management unique?

A: I think that the mutual fund is actually interesting because you are only holding six Russell iShares that you know very closely. There is a large-cap growth, large-cap value, mid-cap growth, mid-cap value and small-cap growth and value. For liquidity purposes, relative to the Russell 3000, instead of selling all the individual stocks we'll hold a little bit to cover redemption.

Q: How do you control risk?

A: The value tilt has a tendency to moderate risk, in general. We also have some parameters that won't allow us to go above a certain level or below a certain level. I'm defining risk in that general sense of a tracking error relative to the benchmark and not general market risk. We don't put any kind of options on general market risk. Investors are going to get the market return and hopefully above the market return by us shifting within the market but there's always equity risk and we are not eliminating that.

Q: How do you handle any overlaps in the indices?

A: The tricky situation is for the mid-cap and the large-cap where there's a little overlap, but the model takes that into account and knows what the constituent components are.

Q: Does that mean that you hold six Russell Indices that trade in

the market as the ETFs or you actually hold the securities underlying them?

A: That's a good question. We do hold the six ETFs so we only hold six stocks but those stocks have passed through to 3000 stocks underneath all of them. Replicating that kind of portfolio is expensive and difficult to manage. We had this idea a while ago and it just was not something we could pull off, but with ETFs we can.

Q: Your whole philosophy is that markets go up and down, sectors go in and out of favor, styles go in and out of favor and there are disparities at certain cycles and you basically want to adjust at that level rather than worry about taking an individual security risk.

A: Yes, we have eliminated stock selection and sector selection because within the six size and style boxes we are mimicking the stock weights and the sector weights. We are basically going for the larger industry segment. There is no clear industry term for large-cap growth so I call it an industry segment. So we'd say we like large-cap growth and we like large-cap value. We are not saying we like healthcare within there, or subsequently, we like J & J within there, for example. We are comfortable enough to try and pick out when those segments come in and out of favor and not try to figure out which sectors and stocks will outperform.

Q: But you have at least between 8 and 10 years for back-testing that you can do if you want?

A: Yes, the Russell Indices themselves go back to the early '90s so even if there were not iShares you can see how Russell Mid Cap did back into the early '90s. So we can back-test

for 15 years. The iShares track the indexes so we are comfortable with the index construction because those go back to 1992 - 1993.

Q: Why did you decide to benchmark against the Russell index and not any other index?

A: We didn't pick the S&P indexes because for the most part the S&P indexes would not have level of small-cap exposure we like. A lot of the investment community does benchmark against the Russell index so you have a marketing message. From my perspective, the general investing public still doesn't really address the Russell. Ten years ago it was only the Dow Jones Industrial Average and now it is S&P 500, so at least there is some progress.

Q: Does the fund have a lot of volatility on an annual basis.

A: The fund is young so I can't rely too much on the fund statistics. There is certainly some volatility. We are tracking error risk principally. We are not making market calls. We don't build up cash levels and we don't decide to take some off if we think this quarter's going to look bad for equity. We are nearly 100% invested in the market keeping cash for redemptions.

Q: If small caps start outperforming the large caps, do you start increasing allocation to small caps that you are permitted in the fund or you wait for another month or longer?


A: The second business day of every month we rebalance the model or I may choose to let the model run its course. If I don't like what the model is doing I challenge it. The challenge is on getting good data points and the reason why quantitative models work

well is that we are not trying to find the best stock. We are just saying on average where money is going in and out of and where investors are gravitating towards. But the challenge is always finding good investment factors that are reliable.

Q: Is it true that you always lag 30 days from what has already happened?

A: Well, no, because these regression statistics were forward looking so when we identified them we were looking for factors that predicted 30 days or the next month's performance. It's definitely a forward-looking model.

For example, the indicator on operating margins will show that in general margins are declining in large caps, looking ahead, so we have a signal to lower our allocation in the segment. While you are catching individual statistics you have to think rate of change tends to work better than absolute comparison.

We are looking at historical data points and we are trying to forecast the investment behavior in the coming weeks and months. It does have forward-looking statistics because you have earnings estimates and dispersion of earnings estimates so you have the consensus estimates coming from the companies. A lot of this data is very similar to what fundamental analysts look at. 

PathMaster Domestic Equity Fund

Symbol	PDEAX
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Tel. No.	877-942-8434
Inception	01/17/06

PORTFOLIO

Total Net Assets*	\$23
Avg Mkt Cap (\$ Weighted)*	\$4.7
Average Price/Earnings Ratio	16.77
Average Price/Book Ratio	2.47
Turnover Ratio	80%

INVESTMENT INFORMATION

New Investment	Open
Min Initial Investment	\$1,000
Min Subsequent Investment	\$500
Min Initial IRA Investment	\$500

RISK (AGAINST S&P 500 - 3-YEARS)

Alpha	N/A
Beta	N/A
R-Squared	N/A
Ann. Std Deviation	N/A
Sharpe Ratio	N/A

RETURNS VS. S&P 500 TR INDEX

	PDEAX	Index
1 Year (Cum.)	11.14%	11.83%
3 Year (Ann.)	N/A	10.06%
5 Year (Ann.)	N/A	6.27%

FEES AND EXPENSES

Max Sales Charge - Front**	5.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee	0.00%
Total Expense Ratio	1.50%

PORTFOLIO MANAGER

Richard C. O'Hara	2006
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*millions, across all share classes

**available load waived

Data through: 03/31/07

Source: Company Documents; Lipper

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